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CLUELESS ON CLASSIFICATION: TOWARD REMOVING ARTIFICIAL LIMITS ON CHAPTER 11 CLAIM CLASSIFICATION

by
*Bruce A. Markell**

I. INTRODUCTION

Confirming a plan of reorganization under chapter 11 of the Bankruptcy Code¹ is daunting. A plan proponent² must affirmatively demon-

* Professor of Law, Indiana University School of Law—Bloomington. Portions of this article appeared earlier as Chapter S in *Critical Issues in Chapter 11 Bankruptcies*, a publication to accompany a seminar co-sponsored by the American Bar Association and the Chicago Chapter of the Federal Bar Association which occurred on May 26-27, 1994. Thanks to Douglass Boshkoff, Eva Saha Daniel, and to Leah Lorber, each of whom read an earlier draft of this article. Errors which remain are mine alone.

¹ Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549 (codified at 11 U.S.C. §§ 101-1330), *as amended by* Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. No. 98-353, 98 Stat. 333 (codified as amended in various sections of 11 U.S.C. and 28 U.S.C.); Bankruptcy Judges, United States Trustees and Family Farmer Bankruptcy Act of 1986, Pub. L. No. 99-554, 100 Stat. 3114 (codified as amended in various sections of 11 U.S.C. and 28 U.S.C.); Retiree Benefits Bankruptcy Protection Act of 1988, Pub. L. No. 100-334, 102 Stat. 610 (codified as amended in various sections of 11 U.S.C.); Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, 104 Stat. 1388 (codified as amended in various sections of 11 U.S.C.); Criminal Victims Protection Act of 1990, Pub. L. No. 101-581, 104 Stat. 2865 (codified as amended in various sections of 11 U.S.C.); Crime Control Act of 1990, Pub. L. No. 101-647, 104 Stat. 4789 (codified as amended in various sections of 11 U.S.C. and 28 U.S.C.); Judicial Improvements Act of 1990, Pub. L. No. 101-650, 104 Stat. 5089 (codified as amended in various sections of 11 U.S.C. and 28 U.S.C.); and, Treasury, Postal Service and General Government Appropriations Act of 1990, Pub. L. No. 101-509, 104 Stat. 1389 (codified as amended in various sections of 28 U.S.C.); Department of Commerce Justice, and State, the Judiciary, and Related Agencies Appropriations Act of 1994, Pub. L. No. 103-121, 107 Stat. 1153 (codified as amended in various sections of 28 U.S.C.); and Bankruptcy Reform

strate that it has met all thirteen requirements for confirmation.³ This task is further complicated by two confirmation requirements which seem to duplicate each other. The first, found at section 1129(a)(8)⁴ of the Code, requires each class of the debtor's creditors to approve the plan. The second, section 1129(a)(10),⁵ requires the approval of at least one class of impaired, non-insider, creditors.

The possibility of cramdown provides the most likely explanation for the apparent duplication. Cramdown, a bankruptcy term of art, refers to confirmation which occurs even though the plan proponent has not obtained the assent of all creditor classes. To achieve cramdown, the proponent must meet all other confirmation requirements *and* the plan must be "fair and equitable" *and* not unfairly discriminatory as to the dissenting class.⁶ Section 1129(a)(10) applies in cramdown; even though the plan proponent has not obtained the consent of all classes, it must obtain the consent of at least one impaired non-insider class.

Central to this analysis is the concept of a "class" of claims or interests. *Classes* vote. An impaired *class* must accept. Only dissenting *classes* in a cramdown receive the benefit of the fair and equitable and no unfair discrimination rules.

How are classes defined? This article addresses that question from both a historical and an analytical perspective.⁷ The article then examines

Act of 1994, Pub. L. No. 103-394, 108 Stat. 3146 (codified as amended in various sections of 11 U.S.C., 18 U.S.C., and 28 U.S.C.) [hereinafter Bankruptcy Code or Code].

² Although often the person attempting to confirm a plan will be the pre-petition debtor, the Bankruptcy Code specifically allows other entities to propose a plan. 11 U.S.C. § 1121(c) (1988) (allowing "[a]ny party in interest" to file a plan so long as exclusivity has terminated).

³ 11 U.S.C. § 1129(a)(1)-(13) (1988).

⁴ 11 U.S.C. § 1129(a)(8) (1988).

⁵ 11 U.S.C. § 1129(a)(10) (1988).

⁶ 11 U.S.C. § 1129(b)(1) (1988).

⁷ I do not write on a clean slate. Many thoughtful articles have already appeared which discuss the issues raised in this article. See, e.g., Jeffrey C. Krause, *The Bias of the Courts Against Single-Asset Real Estate Cases Is Creating Bad Law in the Area of Classification*, 22 CAL. BANKR. J. 47 (1994); Linda J. Rusch, *Single Asset Cases and Chapter 11: The Classification Quandary*, 1 AM. BANKR. INST. L. REV. 43 (1993) [hereinafter "Rusch, Classification Quandary"]; David G. Carlson, *The Classification Veto in Single-Asset Cases Under Bankruptcy Code Section 1129(a)(10)*, 44 S.C. L. REV. 565 (1993); Peter E. Meltzer, *Disenfranchising the Dissenting Creditor Through Artificial Classification or Artificial Impairment*, 66 AM. BANKR. L.J. 281 (1992); Linda J. Rusch, *Gerrymandering the Classification Issue in Chapter Eleven Reorganizations*, 63 U. COLO. L. REV. 163 (1992) [hereinafter "Rusch, Gerrymandering and Classification"]; John C. Anderson, *Classification of Claims and Interests in Reorganization Cases under the New Bankruptcy Code*, 58 AM. BANKR. L.J. 99 (1984); Stefan A. Riesenfeld, *Classification of Claims and Interests in Chapter 11 and 13 Cases*, 75 CAL. L. REV. 391 (1987); William Blair, *Classification of Unsecured Claims in Chapter 11 Reorganizations*, 58 AM. BANKR. L.J. (1984); Thomas C. Givens & Linda J. Phillips, *Equality*

the existing reorganization provisions that bear on claim classification and the court opinions that explore these provisions. Too often, these opinions use terms such as "gerrymandering," or "artificial" impairment as emotional support for disallowing certain forms of classification. This article proposes that the current state of the law (at least the majority of it) is presently wrong and continuing to head in the wrong direction.

To replace the current tests and standards, I offer the following as a proposed construction of section 1122, the section of the Code governing classification: courts should permit any classification proposed by a chapter 11 plan unless a dissenter can establish that the challenged classification would combine, to the dissenter's detriment, creditors or shareholders with different non-bankruptcy liquidation priorities. A dissenter can establish detriment if the plan would transfer property or value preserved by the reorganization from the class in which the dissenter has been placed to another class having a different non-bankruptcy liquidation priority. Although somewhat cumbersome, this formulation essentially means that any classification is proper so long as it does not combine claims that have different non-bankruptcy priorities, such as mixing secured and unsecured claims in one class.

This test attempts to honor the structure and history of plan confirmation. It preserves the balance of negotiating power anticipated by the Code and its system of confirmation, giving effect to the compromises inherent in the Code enactment in 1978.⁸ In so doing, it seeks to prevent the involuntary transfer of any portion of the going concern surplus⁹ among non-consenting classes having different non-bankruptcy liquidation priorities.

The test is also fairly mechanical in application; that is, it looks only at the effect of a proposed classification, not at its motive. This limitation is intentional. The Code already provides subjective tests of the parties' motivations — there must be good faith in voting and in proposing the plan.¹⁰ On the other hand, the text of section 1122, as well as the text of

in the Eye of the Beholder-Classification of Claims and Interests in Chapter 11 Reorganizations, 43 OHIO ST. L.J. 735 (1982).

⁸ See *supra* note 1.

⁹ The going concern surplus, loosely defined, is the surplus of value preserved by keeping a debtor in business. One might define the difference to be the premium a person would pay for the debtor as a going concern, as opposed to the price she would pay just for the individual assets of the firm. The premium may be related to the one-time costs of starting any enterprise, the positive externalities arising from the combination of the existing assets, the intangible qualities of the asset combination (commonly called goodwill), or a combination of some or all of these. See *infra* note 12.

¹⁰ 11 U.S.C. §§ 1126(e), 1129(a)(3) (1988).

sections 1124 and 1129(a)(10), says nothing about the subjective motivations of the parties. It looks only to the effect of the proposed plan on a creditor's claim.¹¹

Similar to section 1122, the proposed test says nothing about what claims a plan must classify together. One controversial consequence of this test is that it expressly validates classes regardless of the motive for creating them, and thus essentially gives the plan proponent free reign in classification. I defend this and other consequences of the test through an analysis of the history of classification, the Supreme Court's current views on statutory interpretation, the Bankruptcy Code, and the policy considerations contained in the current Code. In conclusion, the paper illustrates the application of this standard in common chapter 11 situations.

II. WHY CLASSIFY CLAIMS?

To answer the question posed by the section heading, begin by examining the typical business debtor. It has substantial assets, has given someone a security interest in some or all of these assets, owes taxes and wages, and has a fair amount of unsecured trade credit. Add to this mix an inability to pay all of its debts as they become due. With some form of debt relief, however, this debtor will continue and be worth more than if it is liquidated.

If we really believe that the business is worth more together than apart,¹² a key issue will be choosing the best form of debt relief to pre-

¹¹ 11 U.S.C. §§ 1122, 1124, 1129(a)(10) (1988).

¹² This is a fundamental assumption in reorganizations. As stated in the legislative history of the Code:

The purpose of a business reorganization case, unlike a liquidation case, is to restructure a business's finances so that it may continue to operate, provide its employees with jobs, pay its creditors, and produce a return for its stockholders. The premise of a business reorganization is that assets that are used for production in the industry for which they were designed are more valuable than those same assets sold for scrap. Often, the return on assets that a business can produce is inadequate to compensate those who have invested in the business. Cash flow problems may develop, and require creditors of the business, both trade creditors and long-term lenders, to wait for payment of their claims. If the business can extend or reduce its debts, it often can be returned to a viable state. It is more economically efficient to reorganize than to liquidate, because it preserves jobs and assets.

H.R. REP. NO. 595, 95th Cong., 1st Sess. 220 (1977).

The Supreme Court has also spoken, in passing, about the purpose of chapter 11. *See, e.g.,* NLRB v. Bildisco & Bildisco, 465 U.S. 513, 528 (1984) ("The fundamental purpose of reorganization is to prevent a debtor from going into liquidation, with an attendant loss of jobs and possible misuse of economic resources."); *United States v. Whiting Pools, Inc.*, 462 U.S. 198, 203 (1983) ("By permitting reorganization, Congress anticipated that the business would continue to provide jobs, to satisfy creditors' claims, and to produce a return for its owners. . . . Congress presumed that the assets

serve that value. A system could be developed where a government agent, such as a paid administrator or a standing trustee, selects the form of reorganization. Some commentators argue that the present chapter 11 is closer to this system than we care to admit,¹³ but presently that is not what we have. Under chapter 11, the participants or some subset of them help to select the form of reorganization.¹⁴ Confirmation cannot occur unless every impaired class has the opportunity to accept or reject the proposed reorganization plan.

A. *The History of Classification*

Creditors did not always vote in the manner that they do today. Current reorganization statutes are a mosaic of two distinct lines of reorganization thought. The first, which I call the “democracy” or “creditor-centered” approach, minimized the involvement of a court. It gave effect to the decision of a pre-defined number or percentage of creditors as to the form and extent of debt relief. The second, which I call the “administrative” or “creditor-protective” approach, integrated a court or an administrative agency into the process of determining whether a particular form of debt relief was proper.

1. *Compositions and Arrangements*

The creditor-centered approach finds its origins in the way the common law treated the composition of creditors. Under common law, a debtor in financial difficulty would enter into a master contract with most or all of its creditors for debt relief. These contracts, known as composi-

of the debtor would be more valuable if used in a rehabilitated business than if ‘sold for scrap.’”).

This assumption has long historical roots. After the passage of the 1861 British Bankruptcy Act, see *infra* note 19, which was the first act to allow a majority of creditors to bind a dissenting minority to keep the debtor in business, the following testimony was given:

Of course, under compositions much larger dividends are paid, because either in bankruptcy or under assignments you deal with the debtors’ [sic] estate at winding-up prices; whereas, under compositions, you deal with it as a going concern, and you receive dividends larger in proportion.

Report from the Select Committee on the [English] Bankruptcy Act [of 1861]; Together with the Proceedings of the Committee, Minutes of Evidence, Appendix and Index 84 (1864) [hereinafter “1861 English Report”] (testimony of Mr. Federic John Reed, English solicitor).

¹³ See, e.g., James W. Bowers, *The Fantastic Wisconsin Zero-Bureaucratic-Cost School of Bankruptcy Theory: A Comment*, 91 MICH. L. REV. 1773 (1993).

¹⁴ This point comes about after a combined reading of § 1129(a)(8) and 1129(a)(10) of the Code. Pursuant to § 1129(a)(8), a consensual reorganization requires the consent of all classes of creditors and equity security holders. Even in a non-consensual reorganization, however, § 1129(a)(10) requires at least one class of impaired, non-insider, creditors to consent.

tion agreements, could modify maturity dates, interest rates, or other terms of the debt owed. Creditors who did not sign the composition agreement were not affected by the sacrifices contained in the document.¹⁵ This flowed from the common law notion that an entity was not bound unless it assented to the change.¹⁶

Starting in 1874, federal legislation attempted to foster compositions by providing that, if certain procedural requirements were met, a less than unanimous composition could be confirmed by a bankruptcy court.¹⁷ Its terms would then become binding on all creditors, even those who did not agree with the composition.¹⁸ The 1874 legislation, which had its roots in English¹⁹ and Scottish²⁰ law, bound dissenting creditors if two

¹⁵ RICHARD F. BROUDE, REORGANIZATIONS UNDER CHAPTER 11 OF THE BANKRUPTCY CODE §§ 1.01, 11.06 (1994).

¹⁶ *Id.* When Congress altered this rule in 1874, see *infra* note 17, at least one court believed Congress' change was in derogation of the common law right of unanimity, and thus strictly construed the provisions of the 1874 legislation. *In re Shields*, 21 F. Cas. 1308, 1309 (D. Iowa 1877) (No. 12,284).

¹⁷ Act of June 22, 1874, ch. 390, § 17, 18 Stat. 178 (repealed 1878) (amending § 43 of the Bankruptcy Act of 1867) [hereinafter "1874 Act"].

¹⁸ *Id.*

¹⁹ The Bankruptcy Act of 1869, 32 & 33 Vict., ch. 71, § 126 (Eng.) [hereinafter "1869 Act"]. This section allowed for a court-approved composition as an alternative to bankruptcy. The alternative was attractive since unanimity of creditor approval was not necessary. Instead, any composition approved by a majority in number, and 75% in value, of creditors at a duly convened meeting would bind dissenting creditors. *Id.*

In calculating approval, creditors holding debts of ten pounds or less counted for the value requirement only, but not for the numerosity requirement. *Id.* Although this section permitted secured creditors to vote at the general meetings, another section limited their vote by stating that "[a] secured creditor [was] for the purposes of voting, . . . deemed to be a creditor only in respect of the balance (if any) due to him after deducting the value of his security." *Id.* at § 16(4).

The 1869 Act simply carried forward the innovations incorporated in the English Bankruptcy Act of 1861. Act of 1861, 24 & 25 Vict., ch. 134 (1861) (Eng.) (Amending law relating to bankruptcy in England) [hereinafter "1861 Act"]. Under this Act, compositions were also binding on all creditors if agreed to by a majority in number of creditors holding 75% of the amount of claims. *Id.* at §§ 187 and 192. When calculating the number and amount voting, the Act excluded the claims of creditors who owed less than ten pounds. *Id.* at § 192(1) and (5).

After passage of the 1861 Act, Parliament appointed a committee to investigate the implementation of the Act. The committee heard testimony from both Scotland and Ireland on the required level of creditor assent. See 1861 English Report, *supra* note 12, at 112-13 (statement of Mr. James Wyllie Guild, Scottish accountant and testimony of Mr. Henry Oldham, Irish solicitor). The committee also heard testimony on the effectiveness of, and satisfaction with, the composition provisions of the 1861 Act. *Id.* at 84-85 & 185 (testimony of Mr. Federic John Reed, English solicitor and testimony of Mr. Darnton Lupton, President of the Leeds). Given the continuance of the majority in number and 75% in value requirement, it appears that local satisfaction with the composition provisions prevailed.

Earlier English law provided for a variety of compositions, each of which, however, required a *cessio bonorum*; that is, a bankrupt is required to "turn over all his property to his creditors, in order to make the composition valid in case there were dissenting creditors." WM. MILLER COLLIER, THE

requirements were met: first, approval by a majority of creditors, holding three-quarters of the debt owed, who were present at a duly convened meeting of creditors, and second, written confirmation of the earlier approval by at least two-thirds of all the debtor's creditors who themselves held at least a majority of the debt owed by the debtor.²¹

In making these calculations, all creditors holding claims less than fifty dollars and secured creditors holding deficiency claims were not considered when determining whether the necessary number of creditors agreed. The debts of both classes, however, were counted when determin-

LAW OF BANKRUPTCY AND THE NATIONAL BANKRUPTCY ACT OF 1898 115-16 (1899); Act of 1824, 6 GEO 4, ch. 16, § 133 (1824) (Eng.) (providing for binding composition if 90% of the creditors actually voting, who held claims in excess of twenty pounds, agreed to composition); Act of 1849, 12 & 13 Vict., ch. 106, § 215-16 (1849) (Eng.) (providing for binding public arrangement if consented to by 60% of creditors, in number and value, holding proved debts of ten pounds or more); 1861 Act § 224 (providing for binding private composition if agreed to by 6/7 of all creditors holding debts of ten pounds or more); 1861 Act § 230-31 (providing for binding composition after adjudication of bankruptcy if agreed to by 90% of the voting creditors, holding claims in excess of twenty pounds). The 1861 legislation did away with the requirement that the debtor turn over all of his or her property, and the 1869 legislation kept this change. See COLLIER, *supra*.

²⁰ Bankruptcy (Scotland) Act of 1856, 19 & 20 Vict., ch. 79 (1856) (Eng.). Under this Act, a majority of creditors holding at least 80% in value could "sist," or stay, the bankruptcy proceedings, for a maximum of two months, in order to effect an arrangement. *Id.* at § 35. If during that time 80% of the creditors holding 80% of the claims agreed, they could force the terms of a composition on unwilling minorities. *Id.* at § 38. The debtor could also offer a composition at the meeting for the election of trustee or at the meeting held after his examination. *Id.* at § 139. The debtor's offer of composition must receive an affirmative approval of 90% of all creditors. *Id.* at §§ 137-38. In any case, the debtor received a discharge from all debts subject to a surrender of all property to the jurisdiction of the "Lord Ordinary," that is, the equity judge, or sheriff. *Id.* at § 140.

²¹ 1874 Act § 17. The actual threshold amounts for approval were initially taken from the 1869 British Act, but were the subject of open negotiation between the House and Senate. 2 CONG. REC. 1143, 1268 (1874) (statement of Sen. Edmunds). The House, it seems, wanted a simple majority. *Id.* at 5061. The Senate, spurred by letters from business leagues, however, saw the matter as "a business question" and held to higher percentage requirements. *Id.* at 1268 & 5066. As explained by Senator Edmunds:

I believe that this is substantially in accordance with the English act of composition, though I think [the second vote] in the English law requires only a half of each; but as we have made the earlier part of the composition a little more favorable to the creditors than the English law did in some respects, I think it right, as this discharges a debt due to a man against his consent by a proposition to give time instead of winding up the estate, that it should take a little greater number of people to consent to it than is provided for in the English law under the other circumstances.

Id. at 1352.

Collier also traced the 1874 legislation to § 126 of the 1869 English legislation. See COLLIER, *supra* note 19, at 115. See also 2 CONG. REC. 1143, 1352 (1874) (statement of Sen. Edmunds); *In re Scott, Collins & Co.*, 21 F. Cas. 805, 806-10 (E.D. Mo. 1876) (No. 12,519) (comparing similar provisions of 1874 American Act with 1869 British Act).

ing whether there was sufficient amount of debt in agreement.²² Fully secured creditors were not counted at all, unless they "relinquish[ed their security]" for the benefit of the estate.²³

The 1874 legislation had a short life, being repealed in 1878.²⁴ Starting with section 12 of the 1898 Act, however, compositions became an integral part of federal bankruptcy legislation.²⁵ Section 12 of that Act carried forward the notion of the composition,²⁶ but for reasons that are not clear, lowered the threshold of assent to simply a majority in number and amount of the creditors.²⁷ The 1898 Act also added explicit requirements that the court find the composition to be in the "best interests of creditors" and that it was proposed in "good faith."²⁸

²² 1874 Act § 17.

²³ *Id.*

²⁴ Act of June 7, 1878, ch. 160.

²⁵ Bankruptcy Act of 1898, ch. 541, 30 Stat. 544, § 12 (repealed 1934) [hereinafter the "Bankruptcy Act"]. In the interim, Massachusetts enacted a law specifically providing for an insolvency discharge through the composition format. 1884 Mass. Acts, ch. 195-99, *as amended by* 1885 Mass. Acts, ch. 811-12, 1889 Mass. Acts, ch. 1090-91, 1890 Mass. Acts, ch. 350-51, 1897 Mass. Acts, ch. 216-18. Under this law, a majority in number and value of "general creditors," whose claims had been proved, was necessary to confirm a composition if it returned at least 50% to creditors; a 75% vote was required if the return to creditors was less than 50 cents on the dollar. 1885 Mass. Acts, ch. 811-12. In all cases, priority claims did not count for either the numerosity or the value requirement, and claims less than \$50 did not count for the numerosity requirement. Bankruptcy Act § 2.

As originally enacted, the vote had to be of all creditors, not just those with proved claims. 1884 Mass. Acts, ch. 197. The 1885 amendments changed this to the vote of creditors with proved claims to make it easier for debtors to confirm compositions. 1885 Mass. Acts, ch. 811-12. *See Fenton v. Graham*, 161 Mass. 554, 556 (1894). Finally, from 1884 until 1897, corporations could not take advantage of the composition provisions. 1884 Mass. Acts, ch. 199 and 1897 Mass. Acts, ch. 216.

²⁶ Bankruptcy Act § 12. These provisions resembled the 1874 provisions, but differed in that while the 1874 legislation permitted a composition either before or after adjudication of bankruptcy, the original 1898 Act only allowed a composition after the debtor had been adjudicated a bankrupt. The 1910 amendments to the 1898 Act changed this so that a debtor could propose a composition before, as well as after, adjudication as a bankrupt. Act of June 25, 1910, Pub. L. No. 61-294, ch. 412, 36 Stat. 838.

²⁷ During the debates on the 1898 Act, the following response was given as to why the threshold was not left at two-thirds:

You might just as well say, 'Why not leave it to seven-eighths or nine-tenths?' A *majority seems to be the rule of life in such matters*. The only intent of this was to get an absolute settlement . . . [¶] And we have further protection by providing that if within six months after the adjudication has been made it is shown that fraud was perpetrated, the composition can be reopened . . ."

28 CONG. REC. 4540 (1896) (statement of Rep. Henderson) (emphasis added). Indeed, it appeared many viewed the composition provisions, with their lower standards of acceptance, as a palliative to the provisions of the bill which made it easier to file an involuntary proceeding. 30 CONG. REC. 602 & 629 (1897) (statements of Sen. Lindsay and Sen. Hoar).

²⁸ Bankruptcy Act § 12d. These additions were designed to allow creditors to "pass upon the honesty of a debtor and to calculate the worth of their claims." 25 CONG. REC. 2783 (1893) (remarks

Chapter XI, enacted in 1938, began as an amendment to section 12.²⁹ Chapter XI expanded the requirements of a composition, but continued the notion of a majority in number and amount as the necessary threshold for binding minorities.³⁰ This legislation also explicitly provided for segmentation of unsecured claims, the only claims which chapter XI purported to effect, into different classes.³¹

2. *Equity Receiverships and Chapter X*

As was the case with section 12 compositions, chapter XI had several drawbacks. The rights of secured creditors³² and the interests of equity holders could not be affected absent the unanimous consent of those involved.³³ When the major railroads and other large companies of the day needed reorganization, however, they had to deal with diverse groups of secured creditors and equity holders.³⁴

and analysis of Rep. Oates).

²⁹ 1A COLLIER ON BANKRUPTCY ¶ 12.01, at 1231 (14th ed. 1978). The move to amend § 12 was sponsored by various associations representing creditors. SEC v. United States Realty & Imp. Co., 310 U.S. 434, 450 n.8 (1940).

³⁰ 11 U.S.C. § 762(1) (original version at July 1, 1898, ch. 541, as amended by § 362(1), June 22, 1938, ch. 575, 52 Stat. 911) (repealed 1979)).

³¹ 11 U.S.C. § 757(1) (original version at July 1, 1898, ch. 541, as amended by § 357(1), June 22, 1938, ch. 575, 52 Stat. 840) (repealed 1979)).

When Congress was reforming the bankruptcy laws in the 1930s, the House of Representatives had passed a bill which provided for non-consensual compositions if its terms were fair. This was ultimately rejected by the Senate, and the 1933 revision to § 12 (moving it to § 74) did not change the majority approval provision. See S. REP. NO. 1215, 72d Cong., 2d Sess. 3-4 (1933) (stating that if a majority of creditors would not accept a proposed composition, then "[i]t is not believed to be a practical thing to impose this duty [of involuntarily adjusting debts] upon a referee in bankruptcy, a Federal judge, or any other human being, for that matter. No person ought to be compelled to sit in judgment upon the application of a debtor to protect him and his property from creditors who are insisting that the money due them be promptly paid.").

³² An early edition of COLLIER indicated that "[s]ecured claims will be counted [in a § 12 composition] only to the amount unsecured; they can be 'allowed' only to such amount." 1 COLLIER ON BANKRUPTCY § 12 IV(e)(3), at 319 (12th ed. 1921). The treatise goes on to state that "[m]ortgagees whose debts are dependent solely upon the contingency of a deficiency arising upon foreclosure are neither necessary nor proper parties to a proposed composition." *Id.*

³³ As a consequence, in 1938, Congress made explicit what had been implicit under § 12: that arrangements were only for the adjustment of the rights of unsecured creditors. 11 U.S.C. §§ 706(1), 707 (repealed 1979). For a general overview of the weaknesses of compositions as applied to large corporations, see 6 COLLIER ON BANKRUPTCY ¶ 7.41, at 1334-35 (14th ed. 1978).

³⁴ As stated in the legislative history of § 77:

These [composition] provisions, as now drawn, are obviously unavailable for the adjustment of the claims of creditors and security holders involved in the reorganization of a large corporation, not because the principle of composition is inapplicable to such cases but merely because the statute is not drawn to meet the complexities of the situations

Before 1933, equity receiverships were the primary vehicle used to reorganize these entities.³⁵ In these cases, courts adopted a more creditor-protective point of view. They independently scrutinized the fairness of the proposed plan of reorganization and only allowed voting after they determined that the reorganization's terms were fair.

After 1933, railroad reorganizations proceeded under section 77,³⁶ while reorganizations for other corporate entities proceeded under section 77B³⁷ (before 1938) or chapter X (until 1979).³⁸ Each of these provisions chose an affirmative "two-thirds in amount of claims or interests" to approve a plan.³⁹

These reorganizations were also more creditor-protective. Under these systems, an affirmative vote of the creditor body was not sufficient to confirm a good faith plan. Following the lead of equity receiverships, the plan proponent had to comply with the absolute priority rule for *every* creditor.⁴⁰ Moreover, since the reorganization could affect more than just unsecured creditors, questions arose regarding how to organize the participants by class, and what each classification could do.

Some of these questions were handled by legislation. Both section 77B and chapter X required the court to divide creditors and stockholders into classes according to their interests.⁴¹ With respect to a lender's deficiency claim, section 77B permitted, but did not mandate, the court to "classify as an unsecured claim, the amount of any secured claim in excess of the value of the security therefor"⁴² Chapter X was more specific; it stated that the court "shall . . . determine summarily the value of the security and classify as unsecured the amount in excess of such value."⁴³

Claims which were paid in full or which were not affected, were not

presented.

S. REP. NO. 1215, 72d Cong., 2d Sess. 17 (1933).

³⁵ Bruce A. Markell, *Owners, Auctions, and Absolute Priority in Bankruptcy Reorganizations*,

44 STAN. L. REV. 69, 75 (1991) [hereinafter Markell, *Owners, Auctions*].

³⁶ Act of March 3, 1933, ch. 204, § 77, 47 Stat. 1467, 1474.

³⁷ Act of June 7, 1934, ch. 424, § 77B, 48 Stat. 911, 912.

³⁸ 11 U.S.C. §§ 501-676 (repealed 1979).

³⁹ Act of March 3, 1933, ch. 204, § 77(e), 47 Stat. 1467, 1478; Act of June 7, 1934, ch. 424, § 77B(e)(1), 48 Stat. 911, 918; 11 U.S.C. § 579 (repealed 1979).

⁴⁰ Markell, *Owners, Auctions*, *supra* note 35, at 84-85.

⁴¹ Act of June 7, 1934, ch. 424, § 77B(e)(6), 48 Stat. 911, 916; 11 U.S.C. § 197 (repealed 1979).

⁴² Act of June 7, 1934, ch. 424, § 77B(b)(5), 48 Stat. 911, 916; 11 U.S.C. § 597 (repealed 1979).

⁴³ 11 U.S.C. § 197 (repealed 1979).

placed in a class and thus did not vote on the reorganization.⁴⁴ Finally, Congress believed that claims having different liquidation priorities should be placed in different classes.⁴⁵

These reorganizations adopted a more administrative approach. As an initial matter, chapter X required a higher level of class acceptance. Acceptance occurred only with the approval of "two-thirds in amount of the claims filed and allowed of each class."⁴⁶ In addition, under the absolute priority rule, reorganizations could not be confirmed unless each senior claimant received its full share of reorganization value before any junior claimant could retain an interest in the reorganized entity.⁴⁷ Chapter XI, at least after 1952, contained no such provision.⁴⁸ Chapter X also required the automatic appointment of an independent trustee to run the business until it reorganized, if the indebtedness was \$250,000 or more.⁴⁹ In chapter XI, the debtor remained in possession unless a party in interest sought the appointment of a trustee or receiver.⁵⁰ Finally, chapter X required a higher percentage of creditor approval before minorities were bound. Chapter X required an affirmative vote from creditors holding two-thirds of the amount of debt affected,⁵¹ while chapter XI continued the majority in number and amount from the earlier composition

⁴⁴ Act of June 7, 1934, ch. 424, § 77B(b)(5), 48 Stat. 911, 914. For chapter X, see COLLIER, *supra* note 33, at 1338.

⁴⁵ Act of June 7, 1934, ch. 424, 48 Stat. 911, 915 (1934) (incorporating priority rules from equity receivership practice); S. REP. NO. 510, 73d Cong., 2d Sess. 6 (1934). The practice of separately classifying priority claims can be traced back to the 1884 Massachusetts composition statute. See *supra* note 25. This practice of separately classifying priority claims carried over into chapter X practice. COLLIER, *supra* note 33, at 1601.

⁴⁶ Bankruptcy Act § 179, 11 U.S.C. § 579 (repealed 1979). Chapter XII, which applied to non-corporate real estate reorganizations, also enabled debtors to modify the rights of creditors holding different liquidation priorities, including mortgage holders and unsecured creditors. *Id.* at §§ 406-526. This chapter also required a two-thirds vote of each affected class for confirmation. *Id.* at § 468(1). The differences are explored in Rusch, *Gerrymandering and Classification*, *supra* note 7, at 189-92.

⁴⁷ *Case v. Los Angeles Lumber Prods. Co.*, 308 U.S. 106, 115 (1939). Recall that in *Case*, the complaining bondholder held but \$13,500 of a \$3,800,000 bond issue. Markell, *Owners, Auctions*, *supra* note 35, at 84 n. 101.

⁴⁸ Pub. L. No. 82-456, § 35, 66 Stat. 420, 433 (1952). See also Markell, *Owners, Auctions*, *supra* note 35, at 92 n. 152. Chapter XII also did not require plans to be fair and equitable. Bankruptcy Act §§ 472-526, 11 U.S.C. § 872 (repealed 1979).

⁴⁹ Bankruptcy Act § 156, 11 U.S.C. § 556 (repealed 1979).

⁵⁰ Bankruptcy Act § 342, 11 U.S.C. § 742 (repealed 1979).

⁵¹ Bankruptcy Act § 216(7), 11 U.S.C. § 616(7) (repealed 1979). If the debtor was solvent, equity interests could be modified by only a majority vote. Bankruptcy Act § 216(8), 11 U.S.C. § 616(8) (repealed 1979).

provisions.⁵²

3. *The Mosaic*

Congress attempted to fuse these two strands of reorganization in 1978. With the adoption of the Code, Congress created one form of reorganization instead of several. This new form of reorganization, titled chapter 11, resembled a mosaic of previous practice. Congress chose chapter X's full scope of relief, but retained chapter XI's concept of a debtor in possession.⁵³ Exclusivity from chapter XI also remained, but in combination with a modified version of chapter X's absolute priority rule.⁵⁴

Classification presented a different issue. One Code innovation was the modification of chapter X's absolute priority rule. It continued as the baseline for non-consensual reorganizations, but with a twist. Absolute priority rights were no longer creditor specific—they could now be altered by class vote. Congress combined the chapter X and chapter XI rules to govern this class vote. The result was similar to the solution proposed in 1874: both a numerosity requirement and an amount of debt requirement. Chapter XI provided the numerosity,⁵⁵ more than one-half of the claims voting; chapter X provided the amount,⁵⁶ at least two-thirds in amount of the debt voting.⁵⁷

This may be interesting history, but what relevance does the previous history have on the interpretation of current section 1122? If nothing else, the history of classification constitutes the history of the effort to construct classes so as to enable them to vote on debt relief.⁵⁸ Behind the assumption

⁵² Bankruptcy Act § 362(1), 11 U.S.C. § 762(1) (repealed 1979).

⁵³ Bankruptcy Act § 342, 11 U.S.C. § 742 (repealed 1979); 11 U.S.C. § 1101 (1988).

⁵⁴ Bankruptcy Act § 306(1), 11 U.S.C. § 706(1) (repealed 1979); 11 U.S.C. § 1121 (1988).

⁵⁵ Bankruptcy Act § 362(1), 11 U.S.C. § 762(1) (repealed 1979).

⁵⁶ Bankruptcy Act § 216(7), 11 U.S.C. § 616(7) (repealed 1979).

⁵⁷ As set forth in 11 U.S.C. § 1126(c) (1988):

A class of claims has accepted a plan if such plan has been accepted by creditors, other than any entity designated under subsection (e) of this section, that hold at least two-thirds in amount and more than one-half in number of the allowed claims of such class held by creditors, other than any entity designated under subsection (e) of this section, that have accepted or rejected such plan.

With respect to classes of equity interests, the standard is approval of class members actually voting and who hold "at least two-thirds in amount of the allowed interests of such class . . ." *Id.* at § 1126(d).

⁵⁸ In constructing consent mechanisms for plan confirmation, other questions might arise. For example, is being owed money both a necessary and a sufficient qualification for participating? Section 1165, as did its predecessor § 77 of the Act, provides that in connection with railroad reorganizations, a court is to "consider the public interest in addition to the interests of the debtor, creditors, and

that voting is meaningful lies the notion that some common interest exists among the members of a class. Otherwise, it makes little sense to say that anything less than a unanimous vote could bind dissenters.

The search for commonality among creditors starts with the proposition that all creditors are alike. The 1874 Bankruptcy Act, for example, simply referred to "all the creditors of the debtor."⁵⁹ From this grouping, however, the 1874 Act *excluded* creditors to the extent they were fully secured.⁶⁰ The 1884 Massachusetts Act excluded creditors with priority.⁶¹ The 1898 Bankruptcy Act did not allow compositions or arrangements under chapter XI to affect secured claims or equity interests.⁶²

It is not until the enactment of section 77B in 1934 that distinctions were also drawn among claimholders sharing the same non-bankruptcy liquidation priority. Section 77B distinguished between separate deficiency claims and regular unsecured claims, between unsecured claims which would have had priority in equity receiverships, and those that would not, and between and among various classes of equity securities.⁶³

Bankruptcy law has come a long way from the simple model of secured, unsecured, and equity classes that supported the 1874 legislation. Apart from the rising number of priorities among unsecured creditors, modern financial wizards debate hybrid instruments such as debt which is convertible into or payable in common stock, or common stock which is puttable for cash.⁶⁴ State and federal law contain numerous priorities within the general class of unsecured claims.⁶⁵ The evolution of classifica-

equity security holders." 11 U.S.C. § 1165 (1988). *See also* 11 U.S.C. § 1173(a)(4) (1988) (plan may be confirmed only if "consistent with the public interest").

Second, even if we think creditors are appropriately grouped, do we have confidence in the procedural regularity of the balloting process? All early composition statutes relied upon examinations of debtors under oath to establish that the debtor was not hiding any assets or benefits from creditors. *See supra* notes 17-25 and accompanying text. This practice was carried over into § 12 compositions. Bankruptcy Act § 12. That Act, however, specifically provided that a composition could be set aside for fraud in its procurement. *Id.* at § 13. Section 13 was the forerunner of § 1144 of the current Code.

Finally, will forcing a minority to accept a plan be antithetical to the continuation of the business being reorganized? Current reorganizations address this, if at all, through the notion of feasibility. 11 U.S.C. § 1129(a)(11) (1988).

⁵⁹ 1874 Act § 17.

⁶⁰ *Id.*

⁶¹ *See supra* note 25.

⁶² Bankruptcy Act § 12.

⁶³ *See supra* notes 37-44 and accompanying text.

⁶⁴ *See, e.g.,* Alexander Triantis & George Triantis, *Conversion Rights and the Design of Financial Instruments*, 72 WASH. U.L.Q. 1231 (1994).

⁶⁵ *See, e.g.,* 11 U.S.C. § 507(a) (1988 & Supp. II 1990).

tion appears to follow the evolving complexity of financial life.

If any generality can be drawn from the history of classification, it seems to be this: before 1978, classification under the creditor-protective model prevalent in equity receiverships and chapter X of the 1898 Act was synonymous with non-bankruptcy liquidation priorities. The higher two-thirds requirement for voting reflected a concern for more consensus among creditors given the wider range of possible relief.

Under the democratic model used in compositions and chapter XI, however, a lower level of approval, the simple majority, reflected an assumption that liquidation priorities were not at risk. It also reflected the view that the proper form of consideration could be the subject of reasoned debate, and that the way to expedite arrangements was to lower the consent requirement. This lowering of the threshold for approval effectively took away the veto power that large claims, or large groups of claims, could have.

In other words, and with somewhat more abstraction, pre-Code classification of claims in compositions and arrangements arose as a device to allocate value within a group. Further, since all members of that group shared the same liquidation priority, all members had essentially the same motives with respect to the continuation of the debtor because that decision increased or decreased the return on their claims. In short, voting in classes provided a method of allocating the going concern surplus value within that group.

This abstraction also applied to reorganizations under equity receiverships and chapter X. The ability, however, to implement a far wider range of relief, which in some cases was involuntary, was thought to justify a higher threshold of approval and more ability to create different classes. In addition, the applicability of the absolute priority rule to these reorganizations acted to ensure that there was no non-consensual spillover of going concern surplus from one group to the next.

Under both regimes, dissenting minorities had other means of protecting their interests. Until the Code's adoption, for example, *each* creditor in a chapter XI proceeding could invoke the best interests test. This test ensured that each creditor received an amount equal to its liquidation entitlement.⁶⁶ Each creditor in chapter X had the protection of the absolute priority rule.⁶⁷ Due to the absolute priority rule in chapter X and the limited relief in chapter XI, classification did not greatly concern un-

⁶⁶ Bankruptcy Act § 366(2), 11 U.S.C. § 766(2) (repealed 1979).

⁶⁷ See Markell, *Owners, Auctions*, *supra* note 35, at 83-90.

secured creditors; in theory, before equity could continue to participate in any significant reorganization, it had to ensure that each creditor was paid in full. Although classes could vote on the allocation of value, the vote did not extend to a waiver of priority. Any creditor could object to confirmation based on equity retaining an interest, even if that creditor was a member of a class that voted in favor of the plan.

This system changed in 1978. Although the Code adopted chapter XI's best interests test for each creditor,⁶⁸ it allowed classes to waive what before had been individual absolute priority rights.⁶⁹ This added to the stakes. Classification was no longer a by-word for liquidation priority. Instead, it became a device that could actually alter liquidation priorities. Put another way, classification no longer dealt primarily with allocation of value *within* a class; it became a device for allocation of value *within and among* classes holding different liquidation priorities. The Code thus made individual absolute priority rights subordinate, in many cases, to a majority determination that the debtor should be reorganized.

B. *The Current Rule on Classification*

The words chosen by Congress to accomplish this major change were both important and relatively banal.⁷⁰ Section 1122(a) states that:

[A] plan may place a claim or an interest in a particular class only if such claim or interest is substantially similar to the other claims or interests of such class.⁷¹

Thus, section 1122(a) states a rule of inclusion. It tells us when a plan proponent may place two or more participants in the same class. This follows the historic use of classification as a means of separating creditors with different liquidation priorities and reiterates the legislative history that states that the statute "codifies current case law."⁷² Although Con-

⁶⁸ 11 U.S.C. § 1129(a)(7) (1988).

⁶⁹ See Markell, *Owners, Auctions*, *supra* note 35, at 88.

⁷⁰ The legislative history of § 1122 is reviewed in Rusch, *Gerrymandering and Classification*, *supra* note 7, at 183-86.

⁷¹ 11 U.S.C. § 1122(a) (1988).

⁷² S. REP. NO. 989, 95th Cong., 2d Sess. 118 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5904; H.R. REP. NO. 595, 95th Cong., 1st Sess. 406 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6362. These statements, standing alone, are not much help. Different chapters under the Act used different classification standards. Bankruptcy Act § 357, 11 U.S.C. § 757 (repealed 1979) and Bankruptcy Act § 216, 11 U.S.C. § 621 (repealed 1979). There is also some thought that the interpretations of the standard in each chapter could vary from "court to court." BROUDE, *supra* note 15, at ¶

gress imported the higher acceptance requirements from chapter X, it kept chapter XI's flexibility in sorting classes within the same non-bankruptcy liquidation priority.

Stating the rule, however, tells only part of the story. What section 1122(a) does not explain is when substantially similar claims may be classified *separately*.⁷³ In some respects, this omission is not surprising. Since absolute priority could not be waived by a class prior to 1978, classification had a different function: tracking and confirming liquidation priorities. The modifications, however, made in 1978, and to some extent in 1984, would change how classification was used.

III. COURTS, CLASSIFICATION, AND GERRYMANDERING

A. *Restating the Obvious: Why Classification is Important*

Classification allows a plan proponent to rewrite non-bankruptcy priorities within the bankruptcy priority scheme. Since a plan accepted by all classes can be confirmed even if it violates absolute priority, this ability to mold classes is powerful. Initially, a plan proponent has the opportunity, under the right circumstances, to overwhelm objecting parties by including them in a class filled with sympathetic creditors. Unlike previous bankruptcy practice, dissenting creditors cannot assert violations of absolute priority if the class in which they belong, or have been placed, votes in favor of the plan.

This inability to complain highlights a concept worth some elaboration. Classification does not exist in a vacuum. There must be a plan containing the classification. The ultimate question is not whether a plan contains classification which is permissible, for bad classification presumably can be waived, but whether the plan can be confirmed. Thus, looking at classification without also looking at the plan that contains the classifi-

9.02[1], at 9-8.

⁷³ Many courts recognize this. See, e.g., *John Hancock Life Ins. Co. v. Route 37 Business Park Assoc.* (*In re Route 37 Business Park Assoc.*), 987 F.2d 154, 158 (3d Cir. 1993) ("Section 1122(a) does not expressly provide that 'substantially similar' claims may not be placed in separate classes."); *Hanson v. First Bank of South Dakota* (*In re Hanson*), 828 F.2d 1310, 1313 (8th Cir. 1987) ("We agree that 11 U.S.C. § 1122(a) does not prohibit the placement of substantially similar claims in different classes."); *In re Jersey City Medical Ctr.*, 817 F.2d 1055, 1060-61 (3d Cir. 1987) ("The express language of this statute explicitly forbids a plan from placing dissimilar claims in the same class; it does not, though, address the presence of similar claims in different classes. . . . [W]e agree with the general view which permits the grouping of similar claims in different classes."); *Teamsters Nat'l Freight Indus. Negotiating Comm. v. United States Truck Co.* (*In re United States Truck Co.*), 800 F.2d 581, 584-86 (6th Cir. 1986) (confirming a chapter 11 plan in an operating case which classified union claims separately from other general unsecured claims).

cation provides only a small part of the story.

Plan proponents often structure their classes to ensure confirmation of the plan. Even if no class consented to the proposed plan, the original text of the Code permitted confirmation so long as the plan itself was "fair and equitable" and did not "unfairly discriminate" against non-consenting classes.⁷⁴

B. Section 1129(a)(10) and "Real" Classes of Creditors

This remained the state of the law until 1984 when Congress adopted the Bankruptcy Amendments and Federal Judgeship Act of 1984 (BAFJA).⁷⁵ As part of BAFJA, Congress added section 1129(a)(10).⁷⁶ This section provides that, even in cramdown, at least one impaired class of non-insider creditors must accept the plan. This provision requires some independent validation of the plan; insiders are not counted when determining whether this confirmation requirement is met.⁷⁷

Section 1129(a)(10) thus introduced novel considerations into the strategy of claim classification. Rather than attempting to use classification to overwhelm dissenters, plan proponents began to use it to isolate support. The prototypical situation is that of the real estate debtor with an undersecured creditor. In that situation, the amount of the deficiency claim usually dwarfs all other debts. Therefore, unless separate classification is possible, no plan can be confirmed without the secured creditor's approval.⁷⁸

⁷⁴ Until 1984, it was theoretically possible to confirm a plan without the consent of any class of impaired creditors. This followed the disputed proposition that chapter XII had sanctioned such results. See Rusch, *Gerrymandering and Classification*, *supra* note 7, at 190-91; 9 COLLIER ON BANKRUPTCY ¶ 8.12, at 1080 (14th ed. 1978).

⁷⁵ Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. No. 98-353 (1984).

⁷⁶ 11 U.S.C. § 1129(a)(10) (1988). Professor Rusch reviews the legislative history of § 1129(a)(10) in Rusch, *Gerrymandering and Classification*, *supra* note 7, at 186-89. See also Carlson, *supra* note 7, at 577-82.

⁷⁷ See S. REP. NO. 65, 98th Cong., 1st Sess. 85 (1983) ("Paragraph (10) makes clear the intent of § 1129(a)(10) that one 'real' class of creditors must vote for the plan of reorganization."). See also S. REP. NO. 150, 97th Cong., 1st Sess. 16 (1981).

⁷⁸ See *Windsor on the River Assocs. Ltd. v. Balcors Real Estate Fin., Inc. (In re Windsor on the River Assocs. Ltd.)*, 7 F.3d 127, 132-33 (8th Cir. 1993). See also my discussion of it in Bruce A. Markell, *Eighth Circuit Rule "SAD" News for Single-Asset Cases*, NORTON BANKR. L. ADV. 1 (Dec. 1993). Indeed, the National Bankruptcy Conference has suggested the repeal of § 1129(a)(10). *National Bankruptcy Conference, Reforming The Bankruptcy Code: The National Bankruptcy Conference's Bankruptcy Code Review Project Final Report*, May 1, 1994 at 276-77 (1994).

C. *Classification and the Courts*

Since 1984, courts have read section 1122 through the lens of section 1129(a)(10). They often examine a plan proponent's motives in separately classifying claims, and if that classification serves only to provide a consenting class, the classification is struck down before confirmation. Use of terms such as "gerrymandering"⁷⁹ and "artificial impairment" are liberally sprinkled through these opinions.⁸⁰

While these cases may reach the result anticipated by the Code, they do so for the wrong reason. This can be seen from a short examination of cases construing section 1122, which break into roughly two groups: real estate cases which involve single-asset debtors and those which do not. The single-asset debtors, or SADs,⁸¹ have generated the most litigation.⁸²

1. *Of "SADs"—Single-Asset Debtors—And Other Real Estate Woes*

In SAD reorganizations, every senior lender has a significant and credible strategy. It can propose a liquidation plan or a reorganization plan that is relatively easy to implement: sell the property and then distribute all proceeds in accordance with non-bankruptcy priorities. Even in the event of stalemate and dismissal, the lender still receives the same as it would under a liquidating plan.

Debtors (or, more accurately, debtors' principals) then scramble to salvage their investment, employing everything from "new value" plans to plans containing harsh non-market terms. Without section 1129(a)(10),

⁷⁹ The definitive origins of gerrymandering are set forth in Carlson, *supra* note 7, at 565-66.

⁸⁰ See, e.g., Boston Post Rd. Ltd. Partnership v. FDIC (*In re Boston Post Rd. Ltd. Partnership*), 21 F.3d 477, 481 & 483 (2d Cir. 1994), *cert. denied*, 63 U.S.L.W. 3192, 1994 Westlaw 512684 (U.S. Jan. 17, 1995) (No. 94-442); John Hancock Mutual Life Ins. Co. v. Route 37 Business Park Assocs., 987 F.2d 154, 158 (3d Cir. 1993); Phoenix Mut. Life Ins. Co. v. Greystone III Joint Venture (*In re Greystone III Joint Venture*), 995 F.2d 1274, 1279 (5th Cir. 1991), *cert. denied*, 113 S. Ct. 72 (1992) ("[T]hou shalt not classify similar claims differently in order to gerrymander an affirmative vote on a reorganization plan."); *In re Bloomingdale Partners*, 1994 Westlaw 443684, 25 Bankr. Ct. Dec. 1544 (Bankr. N.D. Ill., Aug. 15, 1994); Meltzer, *supra* note 7.

⁸¹ SADs are entities, usually partnerships, which own one asset, usually an apartment complex or other income producing real property. See 11 U.S.C. § 101(51B) (definition of "single asset real estate"), added by Bankruptcy Reform Act of 1994, Pub. L. No. 103-394, § 218, 108 Stat. 3146 (October 22, 1994). The combination of investment tax credits, depreciation, and various other non-cash charges to income with the pass-through nature of partnership taxation (not to mention government subsidy of the residential real estate market), make SADs an attractive investment opportunity. The roller-coaster nature of the real estate market, however, often converts these investment opportunities into bankruptcy problems.

⁸² An excellent analysis of the problems caused by single-asset debtors is contained in Krause, *supra* note 7.

they could respond with a competing cramdown plan, with the bankruptcy judge and section 1129(c) deciding the outcome. Section 1129(a)(10), however, requires them to find or carve out separate impaired classes to approve the plan.

What is the role of section 1122 in this scuffle? It only tells us when we *cannot* combine claims; it is silent as to when we may separate them.⁸³ The natural reaction to this is to classify separately the lender's deficiency claim, leaving all other unsecured creditors in a different class. There is nothing in the statute preventing this classification. Since the issue is one of separation rather than combination, the statute is silent. Presumably, this silence permits actions not expressly prohibited.⁸⁴

The situation is further complicated by those provisions of the Bankruptcy Code which alter non-bankruptcy priorities. In the real estate context in particular, chapter 11 converts non-recourse deficiencies, which take nothing outside of bankruptcy, into regular unsecured deficiency claims, which do take something inside bankruptcy.⁸⁵ Thus, debtors have attempted to separately classify non-recourse deficiencies in order to create the elusive accepting impaired class from the remaining unsecured creditors.⁸⁶

Until recently, most of these attempts failed. The Second, Third, Fourth, Fifth, and Eighth Circuits have held such separate classification to be impermissible from among the remaining unsecured creditors.⁸⁷ The Fifth Circuit stated its objection cleanly: "thou shalt not classify similar

⁸³ Recall that § 77B and chapter X permitted, but did not mandate, that deficiency claims could be classified with other unsecured claims. Act of June 7, 1934, ch. 424, 48 Stat. 911, 915 (§ 77B) (repealed 1938); 11 U.S.C. § 597 (chapter X) (repealed 1979).

⁸⁴ See *Connecticut Nat'l Bank v. Germain*, 112 S. Ct. 1146 (1992) (By not explicitly amending non-bankruptcy jurisdictional statutes to deny ability to appeal interlocutory orders from district court orders, Congress could not be held to preclude such appeals implicitly through enactment of a scheme specifically dealing with bankruptcy appeals and which precluded such jurisdiction).

⁸⁵ 11 U.S.C. § 1111(b) (1988).

⁸⁶ For a compelling argument that separate classification is mandatory when the debtor's general partner is sufficiently solvent to pay trade claims, see *Carlson*, *supra* note 7.

⁸⁷ *Boston Post Road Ltd. Partnership v. FDIC (In re Boston Post Road Ltd. Partnership)*, 21 F.3d 477, 483 (2d Cir. 1994), *cert. denied*, 63 U.S.L.W. 3192, 1994 Westlaw 512684 (U.S. Jan. 17, 1995) (No. 94-442); *John Hancock Mut. Life Ins. Co. v. Route 37 Business Park Assocs.*, 987 F.2d 154, 161-62 (3d Cir. 1993); *Travelers Ins. Co. v. Bryson Properties, XVIII (In re Bryson Properties, XVIII)*, 961 F.2d 496, 502 (4th Cir.), *cert. denied*, 113 S. Ct. 191 (1992); *Lumber Exch. Bldg. Ltd. Partnership v. Mutual Life Ins. Co. (In re Lumber Exch. Bldg. Ltd. Partnership)*, 968 F.2d 647, 649-50 (8th Cir. 1992); *Phoenix Mut. Life Ins. Co. v. Greystone III Joint Venture (In re Greystone III Joint Venture)*, 995 F.2d 1274, 1281 (5th Cir. 1991), *cert. denied*, 113 S. Ct. 72 (1992). The Bankruptcy Appellate Panel of the Ninth Circuit also agrees. *Oxford Life Ins. Co. v. Tuscon Self-Storage, Inc. (In re Tuscon Self-Storage, Inc.)*, 166 B.R. 892 (Bankr. 9th Cir. 1994).

claims differently in order to gerrymander an affirmative vote on a reorganization plan."⁸⁸

John Hancock Mutual Life Insurance Co. v. Route 37 Business Park Associates presents an illustrative analysis.⁸⁹ In *John Hancock*, the debtor attempted to justify separate classification based on the different treatment of the non-recourse deficiency under state law.⁹⁰ The court gave two basic responses, neither of which is entirely satisfactory. In rejecting separate classification, the court asserted that permitting separate classification would disenfranchise the non-recourse creditor.⁹¹ The court also noted that, regardless of the status under non-bankruptcy law, bankruptcy law equalizes the status on liquidation of unsecured claims and non-recourse deficiency claims.⁹²

As to the first point, only a myopic view of bankruptcy law would see the partially-secured creditor as disenfranchised. Initially, such a claim holder has, and will receive a full distribution in respect of, its secured claim. Receipt of this distribution would be the most that a creditor could expect under non-bankruptcy law or in a chapter 7 liquidation. Second, even if other creditors accept the plan, the plan proponent can confirm over the dissent of the separately segregated deficiency only if the treatment of that deficiency is "fair and equitable" and not unduly discriminatory.⁹³ In short, no junior class can participate and no equal class can unfairly improve its claim. Finally, unless there are no other creditors—in which case dismissal for a lack of a good faith filing might be appropriate—lumping a large, bankruptcy-manufactured claim with unsecured creditors whose claims are not dependent on the chapter of the Code providing relief to the debtor, effectively disenfranchises the smaller creditors.

As to the second point, no one doubts that section 1111(b) stops the debtor from disallowing the deficiency portion of a non-recourse claim in chapter 11.⁹⁴ The limits of this assertion, however, must be examined. First, as noted above, if the case is dismissed or converted to one under chapter 7,⁹⁵ section 1111(b) does not apply. Section 502(b)(1) permits a

⁸⁸ *Greystone III Joint Venture*, 995 F.2d at 1279. An excellent and comprehensive review of all cases in this area can be found in Krause, *supra* note 7.

⁸⁹ 987 F.2d 154 (3d Cir. 1993).

⁹⁰ *Id.* at 159-60.

⁹¹ *Id.* at 161-62.

⁹² *Id.* at 161.

⁹³ 11 U.S.C. § 1129(b)(1) (1988).

⁹⁴ 11 U.S.C. § 1111(b) (1988). If it were not for § 1111(b), § 502(b)(1) would allow estates to disallow any recovery on a deficiency arising in connection with a non-recourse claim.

⁹⁵ A conversion may occur "for cause." 11 U.S.C. § 1112(b) (1988). If the case is converted to

representative of the estate to disallow the creditor's claim for a deficiency because non-bankruptcy law would not recognize it.⁹⁶ Second, this limited life — only in chapter 11 is the deficiency claim recognized — is intentional and integral to the section 1111(b) election. The purpose of that election is to strike a balance between a non-recourse secured lender and the debtor. Although the secured creditor is saved from losing its deficiency claim due to the bankruptcy discharge, in return it must elect to have its entire claim treated as secured. In short, the secured lender gains secured treatment for the full amount of its debt, but loses the right to participate in the plan as an unsecured creditor.

Prohibiting separate classification for creditors who have not made the election — that is, who are willing to risk a discharge of the deficiency claim — gives the secured creditor more than Congress provided. The “more” is an effective veto over reorganization proceedings through control of at least two classes — the main secured class, and the class of unsecured creditors. I use the term “veto” because section 1129(a)(10) precludes the debtor from even proposing “fair and equitable” treatment of the separately classified deficiency.⁹⁷ If Congress had wanted to eliminate all single-asset real estate cases from chapter 11, it could have elected to do so but it did not.⁹⁸ The cases on separate classification, however, achieve by judicial interpretation what Congress did not say in the statute.

This view may change. The Seventh Circuit, after explicitly reviewing most of the circuit cases noted above, recently permitted separate classification of unsecured deficiency claims.⁹⁹ Specifically, the Seventh Circuit stated that “we cannot accept the proposition implicit in *Greystone*

one under chapter 7, the effect is as if the original petition sought relief under chapter 7. 11 U.S.C. § 348(d) (1988).

⁹⁶ 11 U.S.C. § 502(b)(1) (1988).

⁹⁷ 11 U.S.C. § 1129(a)(10) (1988).

⁹⁸ Section 362(d)(3), added by § 218(b) of the Bankruptcy Reform Act of 1994, *see supra* note 81, purports to apply tougher standards to single asset real estate debtors. For example, it provides for faster and more focused relief from the stay. 11 U.S.C. § 362(d)(3) (1994). It exempts these new relief measures, however, in those cases in which “the debtor has filed a plan of reorganization that has a reasonable possibility of being confirmed within a reasonable time.” *Id.* at § 362(d)(3)(A). As stated in the legislative history, “[t]his amendment will ensure that the automatic stay provision is not abused, while giving the debtor the opportunity to create a workable plan of reorganization.” S. REP. NO. 168, 103d Cong., 1st Sess. 46 (1993).

⁹⁹ *In re Woodbrook Assocs.*, 19 F.3d 312, 317-19 (7th Cir. 1994). *Woodbrook* has had a generally favorable reception. *See* *Principal Mut. Life Ins. Co. v. Baldwin Park Towne Ctr., Ltd.* (*In re Baldwin Park Towne Ctr., Ltd.*), 171 B.R. 374 (Bankr. C.D. Cal. 1994); *LW-SP2, L.P. v. Krisch Realty Assocs., L.P.* (*In re Krisch Realty Assocs., L.P.*), 1994 Westlaw 668012 (Bankr. W. D. Va., Oct. 25, 1994). *But see In re Barney and Carey Co.*, 170 B.R. 17 (Bankr. D. Mass. 1994).

that separate classification of a section 1111(b) claim is nearly conclusive evidence of a debtor's intent to gerrymander an affirmative vote for confirmation."¹⁰⁰

The Seventh Circuit's analysis focused on section 1129(a)(7), the so-called "best interests of creditors" test that requires that each creditor receive as much as it would receive in a chapter 7 liquidation.¹⁰¹ Non-recourse deficiencies, however, receive nothing in a chapter 7. Therefore, because section 1123(a)(4) requires the same treatment for each class member,¹⁰² requiring the debtor to classify a non-recourse deficiency claim with other unsecured claims effectively bootstraps a non-recourse lender's minimum recovery to that of a regular unsecured creditor.

The following example illustrates this result. Suppose that a simplified debtor has three creditors, two of which are owed \$100, and one of which is owed \$102. The two owed \$100 have full recourse against the debtor and are unsecured while the third holds a non-recourse claim secured by property now worth one dollar. Although the debtor's business will liquidate for \$201, it has a going concern value of \$298. In a chapter 7 bankruptcy, the non-recourse lender would take one dollar, and the two full recourse creditors would each get \$100. The debtor would take nothing.

If the parties wish to preserve the going concern surplus, the value in excess of \$201, they will attempt to reorganize under chapter 11. This strategy, however, is problematic. If the holdings from *Phoenix Mutual Life Insurance Co. v. Greystone III Joint Venture (In re Greystone III Joint Venture)*,¹⁰³ and *John Hancock* are followed, then the non-recourse creditor's \$101 deficiency¹⁰⁴ will have to be classified with the two recourse creditor claims. This creates a class of \$301 of unsecured claims, and the non-recourse creditor gets its one dollar in security. Since section 1123(a)(4) requires all class members to be treated alike,¹⁰⁵ each member will receive approximately ninety-nine dollars.¹⁰⁶

¹⁰⁰ 19 F.3d at 318.

¹⁰¹ *Id.* at 319.

¹⁰² 11 U.S.C. § 1123(a)(4) (1988).

¹⁰³ 995 F.2d 1274 (5th Cir. 1991), *cert. denied*, 113 S. Ct. 72 (1992).

¹⁰⁴ Due to the disparity between the amount of the debt and the value of the collateral, I assume that the non-recourse creditor will not make the § 1111(b) election. It will thus have two claims in the reorganization: one secured claim in the amount of one dollar, and one unsecured claim in the amount of \$101.

¹⁰⁵ 11 U.S.C. § 1123(a)(4) (1988).

¹⁰⁶ If all of the going concern surplus is allocated to creditors, the dividend is 98.67%. As a result, the recourse creditors will receive \$98.67 in property in satisfaction of their claims, and the

The recourse creditors, however, will not accept the ninety-nine dollars because it is less than their liquidation dividend of \$100. Thus, they could each block confirmation under section 1129(a)(7). On the other hand, if the non-recourse creditor does not receive at least ninety-nine dollars, it can block consensual confirmation since it holds more than one-third (101/301, or 33.55%) of the claims in the class.

This kind of dispute looks much more like an *inter*-class dispute than an *intra*-class concern.¹⁰⁷ Separate classification would better represent the bargaining position outside of chapter 11, since it would recognize the steeper downside to the obdurate lender.

Taking this situation into account, the Seventh Circuit further noted that section 1111(b) anticipates separate classification.¹⁰⁸ In the case of a widely-held secured class, such as a class of secured, non-recourse, bondholders, section 1111(b) allows the class to choose whether it wants to be secured for the full amount of the debt or whether it wants to have a bifurcated claim. As a result, classifying regular unsecured creditors with the non-recourse deficiency claims gives unsecured creditors a vote on matters which either are irrelevant to them or which are none of their business.¹⁰⁹

2. All Other Creditors

What about other creditors — including secured creditors — whose deficiencies would be recognized under non-bankruptcy law? Obviously, this presents a different matter. Since such creditors must share in any value remaining after satisfaction of secured creditors, a different justification for separately classifying a deficiency claim must exist. The cases upholding separate classification of regular unsecured claims offer some guidance. The cases seem to embrace a notion that separate classification can occur if the segregated class has non-creditor motives.¹¹⁰

non-recourse creditor will receive \$99.66, for a total allocation of \$297.

¹⁰⁷ There is an escape hatch. Section 1123(a)(4) allows a member of a class to elect to take "less favorable" treatment than that given to the rest of the class. This option, however, leads to an odd plan. It would offer \$100 to each creditor with a side arrangement that the non-recourse creditor would take "less favorable" treatment. There are, however, problems with feasibility if the plan calls for payments of \$300 when the going concern value is only \$298.

¹⁰⁸ *In re Woodbrook Assocs.*, 19 F.3d 312, 318-19 (7th Cir. 1994).

¹⁰⁹ *Id.* See also *In re SM 104 Ltd.*, 160 B.R. 202, 219-21 (Bankr. S.D. Fla. 1993).

¹¹⁰ See, e.g., *Steelcase Inc. v. Johnston (In re Johnston)*, 21 F.3d 323, 327-28 (9th Cir. 1994) (proper to separately classify an unsecured claim which is being hotly disputed in separate litigation); *Frito-Lay, Inc. v. LTV Steel Co. (In re Chateaugay Corp.)*, 10 F.3d 944, 956-57 (2d Cir. 1993) (finding separate classification of tax lessors based upon whether they independently provided debtor

For now, it is sufficient to say that differential classification of unsecured claims occurs frequently. I discuss later why such cases are common, but first I discuss the reasons why it is desirable to distinguish among such unsecured claims.

IV. A PROPOSAL FOR CHAPTER 11 CLASSIFICATION

There are several practical justifications for differential classification. Creditors who have alternate forms of payment — such as third party guaranties — have different incentives with respect to their claims against the debtor.¹¹¹ Also, creditors who view the debtor as a valuable vendor or customer have more of an interest in the continuation of the debtor than do one-time tort victims of the debtor. Chapters XI and XII of the Bankruptcy Act recognized these distinctions, permitting “division of [unsecured] debts into classes and the treatment thereof in different ways or upon different terms.”¹¹²

As Jeffrey Krause has noted,¹¹³ the taint of SADs has infected and called into question this practical knowledge. In order to return classification to its proper role, I suggest the following construction of section 1122,¹¹⁴ the section of the Code governing classification: courts should permit any classification proposed by a chapter 11 plan unless a dissenter can establish that the challenged classification would combine, to the dissenter's detriment, creditors or shareholders with different non-bankruptcy liquidation priorities. In cases meeting this test, the claims would fail the “substantially similar” requirement in section 1122. Detriment could be established if the plan transfers property or value preserved by the reorganization from the class in which the dissenter has been placed to another class having a different non-bankruptcy liquidation priority.¹¹⁵

in possession financing); *John Hancock Mut. Life Ins. Co. v. Route 37 Business Park Assocs.*, 987 F.2d 154, 159 (3d Cir. 1993) (approving and explaining *In re Jersey City Medical Ctr.*, 817 F.2d 1055, 1061 (3d Cir. 1987), in which separate classification of medical malpractice tort claims, non-priority pension claims, and trade creditors was upheld); *Heartland Federal Sav. & Loan Ass'n v. Briscoe Enter., Ltd., II* (*In re Briscoe Enter., Ltd., II*), 994 F.2d 1160, 1167 (5th Cir.), *cert. denied*, 114 S. Ct. 550 (1993) (upholding separate classification in single-asset real estate case of city which contributed cash to subsidize rentals in moderate to low income housing); *Teamsters Nat'l Freight Indus. Negotiating Comm. v. United States Truck Co.* (*In re United States Truck Co.*), 800 F.2d 581, 587 (6th Cir. 1986) (upholding separate classification of labor union based on such entity's “non-creditor” interests in reorganization).

¹¹¹ COLLIER, *supra* note 33, ¶ 9.10, at 1604.

¹¹² Bankruptcy Act §§ 357(1), 461(3) (repealed 1979).

¹¹³ See Krause, *supra* note 7.

¹¹⁴ 11 U.S.C. § 1122 (1988).

¹¹⁵ At least one bankruptcy court has adopted a standard of classification consistent with this

A. *The Test Expanded*

The proposed test focuses on two related issues: the plan's proposed classification and the effect of that classification on a dissenting creditor or interest holder. A plan's effect is measured by determining whether the plan takes advantage of the Code's innovation of allowing transfers of value between classes having different non-bankruptcy liquidation priorities. The concepts are explored below.

1. *Of Plans and Classification*

Classification cannot exist separately from the plan in which it is contained. In assessing the validity of a classification, the focus should thus be on the plan itself. Since all plans must classify claims,¹¹⁶ the switch from examining classification to examining plans is relatively trivial. The switch does require, however, adoption of the proposition that even theoretically bad classification, such as the combination of secured and unsecured claims, does not provide grounds for objection unless the plan's treatment of a particular claim supplies a separate substantive reason for objection.

This can be illustrated by example. Suppose a plan's primary purpose is to restructure its equity interests.¹¹⁷ In line with this purpose, all claims are classified together, regardless of non-bankruptcy priority and the claims are paid in full, with interest, within ninety days after confirmation. In this example, it would be odd, or at least practically meaningless, to allow a creditor to object to classification of claims.

For these reasons, I propose that although the plan proponent bears the burden of obtaining confirmation,¹¹⁸ the *creditor* should bear the burden of demonstrating impermissible classification. For the most part, since the proposed test is fairly permissive, violations will be easy to assert and prove. Creditors will be able to tell from the required disclosure docu-

test. See, e.g., *In re ZRM-Oklahoma Partnership*, 156 B.R. 67, 70-71 (Bankr. W.D. Okla. 1993).

¹¹⁶ 11 U.S.C. § 1123(a)(1) (1988).

¹¹⁷ See, e.g., *Stolrow v. Stolrow's, Inc. (In re Stolrow's, Inc.)*, 84 B.R. 167 (Bankr. 9th Cir. 1988) (consistent with good faith for solvent debtor to file to resolve difference among owners); *In re Gagel & Gagel*, 24 B.R. 671, 674 (Bankr. S.D. Ohio 1982) (consistent with good faith for solvent debtor to file to restructure secured debts only).

¹¹⁸ *Heartland Federal Sav. & Loan Ass'n v. Briscoe Enter., Ltd., II (In re Briscoe Enter., Ltd., II)*, 994 F.2d 1160, 1164-65 (5th Cir. 1993); *In re Investors Fla. Aggressive Growth Fund, Ltd.*, 168 B.R. 760, 765 (Bankr. N.D. Fla. 1994); *In re Westwood Plaza Apartments*, 147 B.R. 692, 698 (Bankr. E.D. Tex. 1992); *In re MCorp Financial, Inc.*, 137 B.R. 219, 225 (Bankr. S.D. Tex. 1992).

ments¹¹⁹ that the plan combines them with creditors having different liquidation priorities. Creditors will also be able to discern whether lower priority participants will receive under the plan property in excess of their chapter 7 liquidation entitlement.¹²⁰ Any payment of this excess would thus represent a forced sharing of the going concern surplus among participants having different liquidation priorities.¹²¹ If the plan proposes such sharing, detriment to the objecting creditor can be shown because the plan proponent is skewing the vote away from the baseline priorities. Consequently, if any class combines participants having claims of equal priority with participants having lower priority claims, a dissenting creditor can establish improper classification.

What would be accomplished by this? Assume that a plan classifies accrued dividends on preferred stock with unsecured trade claims. Assume further that under applicable non-bankruptcy law, accrued but unpaid dividends have a lower liquidation priority than trade claims; that is, trade claims must be paid in full before any payment is made on the dividends. Dissenting trade creditors could successfully attack this classification by arguing that the plan proponent is using the greater numbers and values of lower priority dividend claims to rob trade creditors of value that is theirs under the absolute priority rule.¹²² A debtor cannot mix the claims having different non-bankruptcy priorities as tools for allocating reorganization value.

2. *Of Non-Bankruptcy Priorities*

The test focuses on *non-bankruptcy* priorities. Historically, these priorities have been the baseline for bankruptcy distributions, unless they contravene some federal interest.¹²³ Section 726 codifies these priorities as a general guideline for liquidation.¹²⁴ It assumes pro rata distribution to all unsecured claims except to the extent that the claims have special pri-

¹¹⁹ Under the Code, any plan proponent must provide creditors and shareholders with information relevant to their decision to accept or reject a plan. 11 U.S.C. § 1125 (1988).

¹²⁰ Section 1129(a)(7)(A)(ii) states that a creditor cannot receive less under a chapter 11 reorganization plan than it would under a chapter 7 liquidation. 11 U.S.C. § 1129(a)(7)(A)(ii) (1988).

¹²¹ See *supra* note 9 and accompanying text.

¹²² Section 1129(b)(2)(B)(ii) provides that a dissenting creditor may insist that a creditor with a lower priority not receive any property until the dissenting creditor is paid. 11 U.S.C. § 1129(b)(2)(B)(ii) (1988). This is commonly known as the absolute priority rule.

¹²³ See *Butner v. United States*, 440 U.S. 48, 55 (1979). Some non-bankruptcy priorities are suspended during bankruptcy. See, e.g., 31 U.S.C. § 3713 (1988) (giving debts owed to the United States priority over all other debts except in the case of federal bankruptcy proceedings).

¹²⁴ 11 U.S.C. § 726(a) (1988).

ority under section 507.¹²⁵ The absolute priority rule, another restriction on distributions, has its origins in state fraudulent transfer law.¹²⁶

The Code also deals with the interactions of classification and the priority rules set forth in section 507. Section 1123(a)(1) specifically prohibits classification of certain types of bankruptcy priority claims.¹²⁷ These include administrative, wage and tax claims.¹²⁸ Section 1123, thus, prohibits, for example, the dilution of administrative trade claims with pre-petition trade claims, or the marginalization of unsecured tax claims by insider debt claims.¹²⁹

3. *Of Detriment: The Involuntary Transfer of Reorganization Value Among Classes*

Under the "democracy" aspect of reorganization, the validity of classification was secondary to the general preferences of the creditor body. The test I propose attempts to take this into account by allowing a creditor to successfully attack suspect classification only if it shows detriment. Detriment, in this sense, accounts for the purpose of classification—regulating transfers of the going concern surplus among classes having mixed liquidation priorities.

As previously indicated,¹³⁰ the going concern surplus is that amount of a debtor's value that contributes to its continued operation. Chapter 11 is based on the idea that this value should be preserved for the benefit of creditors and interest holders.¹³¹ This is evident not only from legislative history and cases construing chapter 11,¹³² but also from the operation of section 1129(a)(7). Section 1129(a)(7) requires a plan proponent to demonstrate that each participant, *not* each class of participants, receive at least as much in reorganization as it would in liquidation.¹³³ Unless there is something more to allocate after the liquidation allocation, chapter 11 has little meaning.

¹²⁵ 11 U.S.C. § 726(b) (1988) (pro-rata requirement). Section 726(a)(1) provides that the first level of distributions should go to claims having priority under § 507. Section 507(a)(1), in turn, directs that administrative expenses under § 503(b) have first priority under § 507.

¹²⁶ See Markell, *Owners, Auctions*, *supra* note 35, at 74-77.

¹²⁷ 11 U.S.C. § 1123(a)(1) (1988). This practice harkens back to the 1884 Massachusetts composition provisions.

¹²⁸ 11 U.S.C. §§ 507(a) (1988 & Supp. II 1990); 503(a) (1988).

¹²⁹ 11 U.S.C. § 1123 (1988).

¹³⁰ See *supra* note 9 and accompanying text.

¹³¹ See *supra* note 12 and accompanying text.

¹³² See *supra* note 12 and accompanying text.

¹³³ See *supra* note 12.

The role of classification in this context is to facilitate the ongoing negotiation over the division of the going concern surplus. This includes the division within the class or classes of creditors, which was the historic function, *and* among classes having different non-bankruptcy liquidation priorities, the innovation of the Code in 1978.¹³⁴ This negotiation has many facets. Creditors and equity holders may have different views on the value of the debtor, the worth of their claims and entitlements, and the risks presented by extended repayment schedules. Classification allows a plan proponent to segment the participants in such a way that while forcing the plan proponent to satisfy the court that each participant will receive an amount equal to liquidation entitlement, requires only a demonstration that a majority of each class has agreed on the division of the going concern surplus.

If, however, a properly constituted class dissents, there are manifold protections. For example, section 1129(b) requires that for any plan to be confirmed over the objection of a class, the plan must be "fair and equitable" and must not "unfairly discriminate" against the dissenting class.¹³⁵ Moreover, confirmation requires that the plan proponent act in good faith,¹³⁶ provide each creditor at least the liquidation value of its claim,¹³⁷ and prove that the reorganization plan proposed is economically feasible.¹³⁸

These requirements are powerful protections for dissenters. They demand that the plan proponent comply with absolute priority as to the dissenting class, and provide acceptable explanations for any differential treatment given to that class. Good faith requires the plan proponent to

¹³⁴ See Rusch, *Gerrymandering and Classification*, *supra* note 7, at 196-206. A question which could be fruitfully explored is whether, under game theory, the Code reaches sensible results with this initial allocation of leverage. See Douglas G. Baird & Randal C. Picker, *A Simple Noncooperative Bargaining Model of Corporate Reorganizations*, 20 J. LEGAL STUD. 311 (1991); Claire Finkelstein, Note, *Financial Distress as a Noncooperative Game: A Proposal for Overcoming Obstacles to Private Workouts*, 102 YALE L.J. 2205 (1993).

¹³⁵ 11 U.S.C. § 1129(b)(1) (1988). See *Principal Mut. Life Ins. Co. v. Baldwin Park Towne Ctr., Ltd.* (*In re Baldwin Park Towne Ctr., Ltd.*), 1994 Westlaw 484456 (Bankr. C.D. Cal., Aug. 2, 1994).

The origins of this protection are in § 77 relating to railroad reorganizations. "The section provides that where two-thirds of a class of creditors accept the plan, then the plan is binding upon that particular class of creditors and the minority must accept the new securities issued under the plan of reorganization. This is fair because all the minority of a particular class should expect is that a fair and equitable plan be devised and if the plan is fair then all they are entitled to is equal participation in the new securities." H. REP. NO. 1897, 72d Cong., 2d Sess. 7 (1933).

¹³⁶ 11 U.S.C. § 1129(a)(3) (1988). See also FED. R. BANKR. P. 3020.

¹³⁷ 11 U.S.C. § 1129(a)(7) (1988).

¹³⁸ 11 U.S.C. § 1129(a)(11) (1988).

proceed in a manner consistent with the purposes of reorganization. In other words, the dissenting class must be paid in full if any junior class retains any interest, and the payment terms of what is received must be near or equal to what other classes of equal non-bankruptcy priorities are receiving.¹³⁹

What protects, however, dissenting creditors in *accepting* classes? Protecting these types of creditors is the true role of classification. Implicit in chapter 11 is the notion that while liquidation priorities are sacrosanct,¹⁴⁰ the allocation of the going concern surplus is not. That view is historic, tracing back to Scottish, English, and Massachusetts insolvency and bankruptcy acts of the Nineteenth century.¹⁴¹

The Code also adopted this view in its structuring and voting provisions; allocation of the going concern surplus is accomplished by creditor consensus. But since it is wasteful to specify each participant's treatment individually, classification is one way to designate distributions collectively, and to use that grouping to obtain consent to the plan. Since we honor state law priorities in the case of dissent, classification performs a gateway or threshold function for application of the absolute priority rule as modified in 1978. It ensures that a group's acceptance of treatment is not obtained at the expense of warping non-bankruptcy liquidation preferences.

In short, classification recognizes that a debtor's creditor body is often composed of many different types of claims, each of which may possess different non-bankruptcy priorities. Moreover, the membership in any one group may not be exclusive; equity holders, for example, often extend credit to their company; secured claims often have associated unsecured

¹³⁹ Against this background, the cases under § 1129(a)(10) which refer to "gerrymandering" and "artificial" classification seem to have jumped the gun. They use classification as a substantive requirement; that is, that classification must serve an ongoing business purpose other than simply obtaining confirmation. This is making the one consenting class rule do too much. It only seeks to block plans which have no creditor support even though they comply with the fair and equitable rules. The "real" class of creditors referred to in the legislative history are creditors who are "really" taking some discount on their claim; that is, those creditors whose treatment makes them impaired within the meaning of § 1124.

Add to these arguments the fact that the § 1129(a)(10) classes lead to absurd or contradictory results and one sees that courts have missed the boat. Sections 1122 and 1129(a)(10) require an almost mechanical construction. First, test whether non-bankruptcy liquidation priorities have been combined. If not, see if at least one accepting, non-insider class has had their non-bankruptcy claim alerted in any respect. If yes, then the dissenters within accepting classes must accept the plan treatment, and dissenting classes can only look to § 1129(b) for grounds to object.

¹⁴⁰ See 11 U.S.C. § 1129(a)(7) (1988).

¹⁴¹ See *supra* notes 17-25.

deficiencies. The prevailing function of classification is to ensure that these chance concordances of status do not influence plan treatment.

How is this tested? Under the proposed test, a court will look at whether the acceptance of a class is tainted by affirmative votes of creditors in that class whose claims or interests have lower non-bankruptcy liquidations priorities. If a court determines that the acceptance is tainted, then the classification is improper because the plan proponent has used classification to allocate reorganization value across the boundaries of non-bankruptcy liquidation priorities.

B. *The Proposed Test and Current Cases on Statutory Construction*

The proposed test is also faithful to the Supreme Court's current views of the proper statutory interpretation of the Bankruptcy Code. Before analyzing this, recall that the Bankruptcy Code stands more or less alone among federal statutes. Construction of its terms is left almost exclusively to the courts; no administrative agency exists which studies and applies its expertise to the meaning of the Code's provisions.¹⁴² Tax statutes, for example, receive scrutiny and review by the Treasury Department; environmental statutes are the provenance of the Environmental Protection Agency; and banking and other financial statutes are reviewed by the Federal Trade Commission and the Comptroller of the Currency, among others.

Partly because of this anomaly, the Supreme Court has issued a series of statutory interpretation cases involving the Code. While the cases are not completely consistent, many take a "plain meaning" approach to the Code.¹⁴³ A summary of this approach might state that the current members of the Court start afresh with the language in question, and then

¹⁴² Under the Bankruptcy Act, the Securities and Exchange Commission was involved in many chapter X cases, and solicitation of its views was mandatory (with adoption of them being advisory) in all cases in which the scheduled indebtedness exceeded \$3,000,000. Bankruptcy Act § 172, 11 U.S.C. § 572 (repealed 1979).

¹⁴³ Of the eighteen Supreme Court bankruptcy cases decided between 1990 and 1993, it is extremely difficult to find any consistent thread or overarching principles. Bruce A. Markell, *Conspiracy, Literalism and Ennui at the Supreme Court: An Examination of Bankruptcy Cases Decided From 1990 to 1993*, 41 FED. B. NEWS & J. 174 (1994). Others have drawn similar conclusions. As Thomas Kelch recently wrote:

It cannot be denied that textualist interpretation presently dominates the imagery of Supreme Court treatment of bankruptcy issues. Even this rhetoric, however, is not consistent. It is vague. It is fragmentary. It is not homogeneous. It is not a "theory" at all. It is a muffled and ill-defined echo of a concept not deserving of the name.

Thomas G. Kelch, *An Apology for Plain Meaning Interpretation of the Bankruptcy Code*, 10 BANKR. DEV. J. 289, 300 (1994).

attempt to apply that language consistent with what they believe to be its proper context. Just what constitutes a proper context is debatable; it seems to range from individual Justices' perceptions unaided by anything other than case law, to legislative history and other statements that might bear on the issue. The Court does seem unwilling, however, to limit construction of the Code simply because Congress may not have considered the full ramifications of its word choice.¹⁴⁴ It also seems satisfied with allowing broad Code provisions to stand.¹⁴⁵

With this background, any analysis of the proper construction of claim classification should start with section 1122. That section states, in full:

- (a) Except as provided in subsection (b) of this section, a plan may place a claim or an interest in a particular class only if such claim or interest is substantially similar to the other claims or interests of such class.
- (b) A plan may designate a separate class of claims consisting only of every unsecured claim that is less than or reduced to an amount that the court approves as reasonable and necessary for administrative convenience.¹⁴⁶

Note that section 1122(a) states only a rule of exclusion — what *cannot*

¹⁴⁴ See, e.g., *Pioneer Inv. Serv. Co. v. Brunswick Assoc. Ltd. Partnership*, 113 S. Ct. 1489, 1495 (1993) ("Courts properly assume, absent sufficient indication to the contrary, that Congress intends the words in its enactments to carry 'their ordinary, contemporary, common meaning.'") (construing Bankruptcy Rule 9006) (*quoting* *Perrin v. United States*, 444 U.S. 37, 42 (1979)); *Patterson v. Shumate*, 112 S. Ct. 2242, 2246 (1992) ("Nothing in § 541 suggests that the phrase 'applicable nonbankruptcy law' refers, as petitioner contends, exclusively to state law. The text contains no limitation on 'applicable nonbankruptcy law' relating to the source of the law.") (construing Bankruptcy Code § 541); *Union Bank v. Wolas*, 112 S. Ct. 527, 531 (1991) ("The fact that Congress may not have foreseen all of the consequences of a statutory enactment is not a sufficient reason for refusing to give effect to its plain meaning.") (construing Bankruptcy Code § 547).

¹⁴⁵ *Taylor v. Freeland & Kronz*, 112 S. Ct. 1644, 1648-49 (1992) (explaining that § 522(l) requires the trustee in bankruptcy to object to debtor's claimed exemptions within 30 day period; there is no implied exception for exemptions taken in bad faith or without any statutory justification); *Barnhill v. Johnson*, 112 S. Ct. 1386, 1390 (1992) (holding that § 101(54) requires that a transfer is made when a check is honored, not when it is delivered); *Connecticut Nat'l Bank v. Germain*, 112 S. Ct. 1146, 1150 (1992) (holding that bankruptcy jurisdictional statute, 28 U.S.C. § 157(d), which gave courts of appeals jurisdiction from appeals of final bankruptcy orders by district courts, does not affect other avenues of appeal from district courts); *Toibb v. Radloff*, 501 U.S. 157, 161 (1991) (holding that § 109(d)'s silence on the business nature of debtor meant that individuals may file chapter 11 even if they are not engaged in business); *Johnson v. Home State Bank*, 501 U.S. 78, 87 (1991) (holding that lack of prohibition in the Bankruptcy Code regarding serial filings meant that debtors may file a chapter 13 case to reorganize home mortgage payments after discharging their personal liability in a chapter 7 case).

¹⁴⁶ 11 U.S.C. § 1122 (1988).

be classified together.¹⁴⁷ It does not state a rule of inclusion — what *must* be classified together. This lack of explicit symmetry questions the relevancy of section 1122 to the question of what claims must be classified together. If in fact it is relevant, questions still exist as to what test section 1122 provides for such combinations.

While the Court has not addressed this issue directly, it has examined other Code provisions that do not completely cover their subject matter.¹⁴⁸ In *Grogan v. Garner*,¹⁴⁹ for example, the Court addressed whether pre-Code practice of assessing the dischargeability of a claim was to be determined by a clear and convincing standard, or by a preponderance of the evidence standard.¹⁵⁰ After noting that “[t]he language of § 523 does not prescribe the standard of proof for the discharge exceptions,”¹⁵¹ the Court began its “inquiry into the appropriate burden of proof under § 523 by examining the language of the statute and its legislative history.”¹⁵² It found that the “legislative history of § 523 and its predecessor, 11 U.S.C. § 35 (1976 ed.), is . . . silent,” and “[t]his silence is inconsistent with the view that Congress intended to require a special, heightened standard of proof.”¹⁵³ It thus adopted the normal federal standard of preponderance of the evidence.

Similarly, in *Connecticut National Bank v. Germain*,¹⁵⁴ the Court addressed the addition to the judicial code of a new section governing appellate jurisdiction in bankruptcy cases.¹⁵⁵ The addition seemed to limit the jurisdiction of circuit courts in appeals from interlocutory orders issued by district courts who act as appellate judges in bankruptcy. The problem was, however, that Congress did not also amend the general stat-

¹⁴⁷ 11 U.S.C. § 1122(a) (1988).

¹⁴⁸ See *Taylor v. Freeland & Kronz*, 112 S. Ct. 1644, 1648-49 (1992) (holding that there is no implied exception for exemptions under section 522(l) that are taken in bad faith or without statutory justification); *Connecticut Nat'l Bank v. Germain*, 112 S. Ct. 1146, 1149 (1992) (holding that it was not the Court's place to close the avenue of appeal left open by 28 U.S.C. § 158(d)); *Grogan v. Garner*, 498 U.S. 279, 286 (1991) (holding that since § 523 did not specify a standard of proof, the normal federal standard of preponderance of evidence should be used).

¹⁴⁹ 498 U.S. 279 (1991).

¹⁵⁰ *Id.*

¹⁵¹ *Id.* at 286.

¹⁵² *Id.*

¹⁵³ *Id.*

¹⁵⁴ 112 S. Ct. 1146 (1992).

¹⁵⁵ *Id.* The statute at issue provided that “[t]he courts of appeals shall have jurisdiction of appeals from all final decisions, judgments, orders, and decrees entered under subsections (a) and (b) of this section.” 28 U.S.C. § 158(d) (1988).

ute regulating interlocutory appeals from district courts,¹⁵⁶ thus leaving open an avenue of appeal.¹⁵⁷ The Court refused to close this avenue, finding that Congress knew how to close it if it wanted to do so.¹⁵⁸

Finally, in *Taylor v. Freeland & Kronz*,¹⁵⁹ the Court was faced with section 522(l), which provided for a limited window for a trustee to object to a debtor's claimed exemptions.¹⁶⁰ The statute did not extend the time for objection if the debtor took the exemptions in bad faith. Nevertheless, a number of lower courts had read such an exemption into the statute.¹⁶¹ The Court, however, refused to read a "bad faith" exception into the debtor's ability to claim exemptions. It was not part of the text chosen by Congress, and thus was not a requirement to be imposed, even though it allowed relatively blatant exemptions to go unnoticed.¹⁶²

These cases and others¹⁶³ indicate that the Court is not comfortable reading additional terms into a statute. As the Court asserts each time the issue is raised, "[w]here the statutory language is clear, our 'sole function . . . is to enforce it according to its terms.'"¹⁶⁴

¹⁵⁶ 28 U.S.C. § 1291 (1988 & Supp. V 1993).

¹⁵⁷ 112 S. Ct. at 1149.

¹⁵⁸ *Id.* at 1149 (1992) ("We have stated time and again that courts must presume that a legislature says in a statute what it means and means in a statute what it says there.").

¹⁵⁹ 112 S. Ct. 1644 (1992).

¹⁶⁰ *Id.* Section 522(l) provides that: "Unless a party in interest objects, the property claimed as exempt on such list is exempt." 11 U.S.C. § 522(l) (1988).

¹⁶¹ *See, e.g.,* Halverson v. Peterson (*In re Peterson*), 920 F.2d 1389, 1393-94 (8th Cir. 1990) (holding that § 522(l) does provide for an extension of time when exemptions are filed in bad faith).

¹⁶² 112 S. Ct. at 1648-49. The Court apparently saw the issue as one of its *power*, as opposed to its *discretion*. As the Court explained, "Congress may enact comparable provisions to address the difficulties that Taylor predicts will follow our decision. We have *no authority* to limit the application of § 522(l) to exemptions claimed in good faith." *Id.*

¹⁶³ *See, e.g.,* Toibb v. Radloff, 501 U.S. 157, 161 (1991) (holding that individuals may file chapter 11 even if they are not engaged in business); Johnson v. Home State Bank, 501 U.S. 78, 87 (1991) (holding that lack of prohibition in Bankruptcy Code regarding serial filings meant that debtors may file a chapter 13 case to reorganize home mortgage payments after discharging their personal liability in a chapter 7 case).

¹⁶⁴ *Rake v. Wade*, 113 S. Ct. 2187, 2191 (1993) (construing § 1322 of the Code) (quoting *United States v. Ron Pair Enter., Inc.*, 489 U.S. 235, 241 (1989) (quoting *Caminetti v. United States*, 242 U.S. 470 (1917))). *See also* *Pioneer Inv. Serv. Co. v. Brunswick Assoc. Ltd. Partnership*, 113 S. Ct. 1489, 1495 (1993) ("Courts properly assume, absent sufficient indication to the contrary, that Congress intends the words in its enactments to carry 'their ordinary, contemporary, common meaning.'") (quoting *Perrin v. United States*, 444 U.S. 37, 42 (1979) (construing "excusable neglect" in rule governing filing of proofs of claim)); *Dewsnup v. Timm*, 112 S. Ct. 773, 779 (1992) ("Of course, where the language is unambiguous, silence in the legislative history cannot be controlling.") (construing § 506 of the Bankruptcy Code); *Toibb v. Radloff*, 501 U.S. 157, 162 (1991) ("First, this Court has repeated with some frequency: 'Where, as here, the resolution of a question of federal law turns on a statute and the intention of Congress, we look first to the statutory language and then to the

Applying these cases to section 1122 is thus relatively easy. Section 1122(a) addresses only improper combinations of claims, not allegedly improper segregation. It is silent on what claims "must" be classified together. According to the Supreme Court, this silence should be construed as a lack of regulation of this aspect, precluding the interpolation of terms such as "reasonable" or "rational" into the statute.¹⁶⁵ The underlying assumption here is that had Congress intended for such modifiers to be inserted, Congress would have placed them there.¹⁶⁶

Examining section 1122(b)'s administrative convenience class exception leads to a similar result.¹⁶⁷ Some might interpret the statute's reference to "unsecured" claims to mean that classification by non-bankruptcy priority is the norm and that this priority can only be varied by meeting the requirements of reasonableness and necessity laid out in subsection (b).

This argument, however, does not address the text of subsection (a) which, regardless of subsection (b)'s text, does not refer to inclusion.¹⁶⁸ Moreover, subsection (b) is expressly excluded from (a), thus negating

legislative history if the statutory language is unclear.'") (quoting *Blum v. Stenson*, 465 U.S. 886, 896 (1984)).

¹⁶⁵ Many courts seem to permit separate classification only if the plan proponent can articulate some reasonable or rational business or economic justification for doing so. *Boston Post Rd. Ltd. Partnership v. FDIC (In re Boston Post Rd. Ltd. Partnership)*, 21 F.3d 477, 483 (2d Cir. 1994); *Steel Case, Inc. v. Johnston (In re Johnston)*, 21 F.3d 323, 328 (9th Cir. 1994); *Oxford Life Ins. Co. v. Tucson Self-Storage, Inc. (In re Tucson Self-Storage, Inc.)*, 166 B.R. 892, 898 (Bankr. 9th Cir. 1994). Under the Court's view of statutory interpretation, these considerations are no more important than those which attempt to assess motivation when examining classification.

¹⁶⁶ On this point, see *Carlson, supra* note 7, at 574.

¹⁶⁷ See, e.g., *Phoenix Mut. Life Ins. Co. v. Greystone III Joint Venture (In re Greystone III Joint Venture)*, 995 F.2d 1274, 1278 (5th Cir. 1991) ("The broad interpretation of § 1122(a) adopted by the lower courts would render § 1122(b) superfluous, a result that is anathema to elementary principles of statutory construction."); *Washington Assocs. v. Citibank, N.A. (In re Washington Assocs.)*, 147 B.R. 827, 830 (E.D.N.Y. 1992) (quoting *Greystone III Joint Venture*, 995 F.2d at 1278).

¹⁶⁸ As stated in *In re Bloomingdale Partners*, 170 B.R. 984, 989-90 (Bankr. N.D. Ill. 1994):

Subsection (b) of § 1122 is not superfluous because it expressly authorizes the joint classification of claims that are not 'substantially similar,' notwithstanding the general prohibition on such joint classification contained in § 1122(a), provided only that the amounts of the claims are less than a certain amount. The first words of § 1122(a) are 'Except as provided in subsection (b) of this section. . . .' Subsection (b) is explicitly an exception to the prohibition contained in subsection (a) against classifying claims that are not 'substantially similar' in the same class. Consequently, the plain language of the Code provides no express guidance concerning any restrictions on the separate classification of 'substantially similar' claims.

Id.

any claim that the two need to be consistent.¹⁶⁹ In short, subsection (b)'s existence can be explained by a desire to legitimize the pairing of claims based not on the relationship of the creditor to the debtor, but simply on the amount of the claim, and the need to ensure that the amount of the dividend check exceeds the amount of postage necessary to send it to the creditor. This interpretation of section 1122 is firmly rooted in history. The English Bankruptcy Act of 1869,¹⁷⁰ the American Bankruptcy Act of 1874,¹⁷¹ and the 1884 Massachusetts Act¹⁷² all explicitly treated smaller claims differently from larger claims.

Traditional legislative intent analysis also supports the proposed construction of section 1122(a). The legislative history of section 1122 simply states that it "codifies current case law surrounding the classification of claims"¹⁷³ Both chapters XI and XII permitted "division of [unsecured] debts into classes and the treatment thereof in different ways or upon different terms"¹⁷⁴ In addition, chapter X provided that a plan "shall include in respect to creditors generally or some class of them, secured or unsecured, . . . provisions altering or modifying their rights"¹⁷⁵ Although Congress used different words in each context, leading to different interpretations,¹⁷⁶ both classification schemes allow separate classification of claims having the same liquidation priority.¹⁷⁷

¹⁶⁹ See *In re ZRM-Oklahoma Partnership*, 156 B.R. 67, 70 n.3 (Bankr. W.D. Okla. 1993).

¹⁷⁰ 1869 Act § 126.

¹⁷¹ 1874 Act § 17.

¹⁷² 1884 Mass. Acts, ch. 195, as amended by 1885 Mass. Acts, ch. 811, 1889 Mass. Acts, ch. 1090, 1890 Mass. Acts, ch. 350, 1897 Mass. Acts, ch. 216.

¹⁷³ S. REP. NO. 989, 95th Cong., 2d Sess. 118 (1978), reprinted in 1978 U.S.C.C.A.N. 5787, 5904; H. REP. NO. 595, 95th Cong., 1st Sess. 406 (1977), reprinted in 1977 U.S.C.C.A.N. 5787, 6362.

¹⁷⁴ 11 U.S.C. § 757(1) (repealed 1979); 11 U.S.C. § 861(3) (repealed 1979).

¹⁷⁵ 11 U.S.C. § 616(1) (repealed 1979).

¹⁷⁶ See BROUDE, *supra* note 15, at ¶ 9.02[2].

¹⁷⁷ Randolph Haines is critical of this interpretation, citing to the text of the Bankruptcy Commission's report. Haines, *supra* note 7, at 2. Courts have also been critical:

It is difficult to follow Congress' instruction to apply the old case law to the new Code provision. The old case law comes from two different sources. Chapter X of the old Act was designed for thorough financial reorganizations of large corporations. It imposed a very formal and rigid structure to protect the investing public. Chapter XI was designed for small nonpublic businesses, did not permit the adjustment of a secured debt or of equity, and thus contained few investor-protection measures. The idea behind Chapter 11 of the Code was to combine the speed and flexibility of Chapter XI with some of the protection and remedial tools of Chapter X. Thus, Congress has incorporated, for purposes of interpreting section 1122, the case law from two provisions with different language, that were adopted for different purposes, and that have been interpreted to mean different things.

As a matter of practicality, we cannot revert to non-bankruptcy law priorities to provide a definition of what must be included in particular classes. That strategy risks making section 1122(a) irrelevant.¹⁷⁸ Indeed, Congress could have done just this by making the chapter 7 distribution provisions mandatory in chapter 11.¹⁷⁹ Under chapter 7, and most non-bankruptcy liquidations, non-priority unsecured creditors are all treated the same. They share pro-rata in whatever is left over after the secured and priority creditors have had their claims paid.¹⁸⁰ Moreover, if history had adopted that view, classification would have been irrelevant in chapter XI, since it could only modify unsecured claims.

In short, if section 1122(a) is supposed to mirror non-bankruptcy law priorities, it could have been done more directly and with less words. Cases and commentators, however, have taken great pains to distinguish the different motives that groups of unsecured creditors with the same liquidation priority might have.¹⁸¹

Teamsters Nat'l Freight Indus. Negotiating Comm. v. United States Truck Co. (*In re United States Truck Co.*), 800 F.2d 581, 586 (6th Cir. 1986).

The original report of the Bankruptcy Commission proposed the following language to handle classification: "The administrator [now the plan proponent] shall designate classes of creditors and equity security holders which are of substantially similar character and the members of which enjoy substantially similar rights." H.R. Doc. No. 137, 93d Cong., 1st Sess., pt. II, at 241 (1973). The note to this section stated that "[t]he liquidation priorities are applicable and claims of a substantially similar nature must be included in the same class, except that small claims may be separately classed." *Id.*

¹⁷⁸ It also may make § 1124's provisions on impairment superfluous, since in a world where all unsecured creditors get equal treatment, there is little need to test impairment as strictly as done in § 1124. See 5 COLLIER ON BANKRUPTCY ¶ 1122.04, at 1122-20 (15th ed. 1993).

¹⁷⁹ See Carlson, *supra* note 7, at 571-72. The chapter 7 distribution provisions are found in 11 U.S.C. § 726 (1988).

¹⁸⁰ Actually, chapter 7 does not treat all non-priority, unsecured claims alike. Any fines, penalties, forfeitures, or multiple, exemplary, or punitive damages are singled out for lesser treatment. 11 U.S.C. § 726(a)(4) (1988).

¹⁸¹ See, e.g., *Steelcase Inc. v. Johnston* (*In re Johnston*), 21 F.3d 323 (9th Cir. 1994) (finding it proper to separately classify unsecured claim which is being hotly disputed in separate litigation); *Frito-Lay, Inc. v. LTV Steel Co.* (*In re Chateaugay Corp.*), 10 F.3d 944, 956-57 (2d Cir. 1993) (holding that separate classification of tax lessors based upon whether they independently provided debtor in possession financing is allowed); *John Hancock Mut. Life Ins. Co. v. Route 37 Business Park Assocs.*, 987 F.2d 154, 159 (3d Cir. 1993) (approving and explaining *In re Jersey City Medical Ctr.*, 817 F.2d 1055, 1061 (3d Cir. 1987)), in which separate classification of medical malpractice tort claims, non-priority employee benefit plan claims, and general trade creditor claims were upheld); *Heartland Fed. Sav. & Loan Ass'n v. Briscoe Enter., Ltd.*, II (*In re Briscoe Enter., Ltd.*, II), 994 F.2d 1160, 1167 (5th Cir. 1993) (upholding separate classification of unsecured claims held by the City of Fort Worth, and other creditors, in single-asset real estate case, where the City contributed cash to subsidize rentals in moderate to low income housing); *Teamsters Nat'l Freight Indus. Negotiating Comm. v. United States Truck Co.* (*In re United States Truck Co.*), 800 F.2d 581, 587 (6th Cir. 1986) (upholding separate classification of labor union based on such entity's "non-creditor"

C. *The Proposed Test and Section 1129(a)(10)*

Some courts and commentators assert that a test such as the one proposed above either makes section 1129(a)(10) a “nullity”¹⁸² or “eradicates completely”¹⁸³ its effects. They argue that Congress could not have had in mind such a flexible standard for section 1122 when enacting section 1129(a)(10).¹⁸⁴

The problem with this argument is its premise. A flexible or expansive reading of section 1122 has little to do with section 1129(a)(10). Only if one believes that section 1129(a)(10) was intended to prevent reorganization of single asset bankruptcies, a result belied by current efforts at bankruptcy reform, can one justify this premise.

To be sure, section 1129(a)(10) incorporates the notion of an “impaired class.”¹⁸⁵ The “class” part of this phrase, however, does not cause the problem. Section 1124 presents the real issue. This section defines impairment as the alteration of *any* of the creditor’s “legal, equitable or contractual rights to which such claim or interest entitles the holder of such claim or interest.”¹⁸⁶ Given the review of recent Supreme Court cases above, it stretches logic to think that the current Court would read section 1124 to mean any *real* or *substantial* alteration.

If we would not insert such concepts into section 1124, why do we think that we can insert them in section 1122? Yet, section 1129(a)(10) really does not do this. The only existing legislative history behind section 1129(a)(10) indicates that Congress was concerned with a “real” class of

interests in reorganization).

¹⁸² *In re Bloomingdale Partners*, 170 B.R. 984 (Bankr. N.D. Ill. 1994).

¹⁸³ See Meltzer, *supra* note 7, at 302.

¹⁸⁴ See, e.g., *Conroy v. Aniskoff*, 113 S. Ct. 1562, 1566 (1993) (Court unwilling to ignore plain meaning unless Court was able to “say that Congress would have found our straight-forward interpretation [of the statute] and application of its words either absurd or illogical.”); *Public Citizen v. Department of Justice*, 491 U.S. 440, 454 (1989) (courts can look beyond statutory language when plain meaning would “compel an odd result”) (citing *Green v. Bock Laundry Mach. Co.*, 490 U.S. 504, 509 (1989)); *EEOC v. Commercial Office Prod. Co.*, 486 U.S. 107, 120 (1988) (plurality opinion) (rejecting the more natural reading of statutory language because such an interpretation would lead to “‘absurd or futile results . . . plainly at variance with the policy of the legislation as a whole’”). Cf. *Connecticut Nat’l Bank v. Germain*, 112 S. Ct. 1146, 1149 (1992) (“We have stated time and again that courts must presume that a legislature says in a statute what it means and means in a statute what it says there.”).

¹⁸⁵ 11 U.S.C. § 1129(a)(7) (1988).

¹⁸⁶ 11 U.S.C. § 1124(1) (1988). Indeed, the Ninth Circuit has found impairment when a creditor’s position was arguably beneficially altered. *L & J Anaheim Assocs. v. Kawasaki Leasing Int’l, Inc.* (*In re L & J Anaheim Assocs.*), 995 F.2d 940, 942 (9th Cir. 1993).

impaired creditors.¹⁸⁷ What does this mean? Many have rushed to the conclusion that this means that the impaired class should be "substantial;" that is, should somehow matter in the reorganization. This may be the wrong lens through which to look at the amendment. It can just as easily be interpreted to address the problem of the "maximum cramdown;" the specter that a plan agreed to by no class of non-insider creditors could be confirmed.¹⁸⁸

Even with an expansive reading of section 1122, section 1129(a)(10) continues to have meaning. It prevents impaired insiders, who may have legitimate debt claims, from counting towards the necessary one class. It also prevents a non-impaired class¹⁸⁹ from being the required class of accepting creditors because at least one class of *impaired* creditors must accept.

Critics argue that this is not enough. They view the purpose of section 1129(a)(10) differently, and see expansive classification as antagonistic to that purpose. One possible response to this argument is that the current Court interprets imputed purpose as subordinate to the actual text used. How else can the Court construe section 522(l) as not requiring good faith?¹⁹⁰ It stretches the imagination to construe the very mechanical nature of sections 1122, 1124, and 1129(a)(10) as containing substantive restrictions on the motives of plan proponents.

This leap of the imagination falls flat when one considers that other provisions of the Code regulate the nexus between the result obtained and the motive used in obtaining that result. If dissenting creditors believe that the vote of the impaired class was improperly obtained, they can seek to disallow it on the good faith grounds explicitly provided for in section 1126(e).¹⁹¹ They can also attempt to thwart the whole plan as not being proposed in good faith, another requirement explicitly provided for in section 1129(a)(3).¹⁹²

¹⁸⁷ See Rusch, *Gerrymandering and Classification*, *supra* note 7, at 186-89.

¹⁸⁸ See *supra* note 139.

¹⁸⁹ A non-impaired class could be a class whose claims are unaltered, or a class whose claims are paid in full. 11 U.S.C. § 1124(1), 1124(3) (1988). For non-impaired classes, the Code presumes acceptance of the plan. 11 U.S.C. § 1126(f) (1988).

¹⁹⁰ Taylor v. Freeland & Kronz, 112 S. Ct. 1644 (1992).

¹⁹¹ See Carlson, *supra* note 7, at 614-16. See also Mutual Life Ins. Co. of N.Y. v. Patrician St. Joseph Partners Ltd. Partnership (*In re Patrician St. Joseph Partners Ltd. Partnership*), 169 B.R. 669 (D. Ariz. 1994).

¹⁹² See Rusch, *supra* note 7, at 202-05. Courts have used subjective standards when construing the good faith requirement of § 1129(a)(3). See, e.g., *In re Madison Hotel Assocs.*, 749 F.2d 410, 424-25 (7th Cir. 1984) (good faith requires that a plan achieve a result consistent with the objectives

The real issue is that it is procedurally cheaper to knock out a plan on classification grounds. If lawyers can present the issue as a question of law, there need be no discovery taken on the motives of the plan proponent. Dissenters can then object to the classification at the disclosure statement stage, rather than during a plan confirmation.

From a policy standpoint, this may make sense. Maybe we should limit what a plan can do before creditors vote. That certainly was the case under equity receiverships and chapter X, but we do not write on a clean slate. The Code attempts to balance all interests, including those held by the debtor.¹⁹³ The language in the Code allows for a low threshold for impairment, and imposes nothing but negative restrictions on classification. This structure, chosen by Congress, should control, not the imputed purposes suggested by others.

D. *The Proposed Test Applied*

A final objection to the proposed test is that it would validate the creation of a class having only one "sympathetic" creditor, whose claim is only trivially altered, and that a plan proponent can use this one-creditor class to cram down a plan over the dissent of more substantial creditors.¹⁹⁴

and purposes of the Code); *Stolrow v. Stolrow's, Inc.* (*In re Stolrow's, Inc.*), 84 B.R. 167, 172 (Bankr. 9th Cir. 1988) (good faith requires that a plan achieve a result consistent with the objectives and purposes of the Code and fundamental fairness in dealing with one's creditors); *In re Jorgensen*, 66 B.R. 104, 109 (Bankr. 9th Cir. 1986) (good faith requires that a plan achieve a result consistent with the objectives and purposes of the Code and fundamental fairness in dealing with one's creditors); *In re New Valley Corp.*, 168 B.R. 73, 80-81 (Bankr. D.N.J. 1994) ("It is generally held that a plan is proposed in good faith if there is a reasonable likelihood that the plan will achieve a result consistent with the objectives and purpose of the Bankruptcy Code. . . . A further refinement of the test for whether a plan is proposed in good faith is found in the notion that the plan must provide for fundamental fairness in dealing with creditors."); *In re Rivers End Apartments, Ltd.*, 167 B.R. 470, 475-76 (Bankr. S.D. Ohio 1994); *In re Gregory Boat Co.*, 44 B.R. 361, 366 (Bankr. E.D. Mich. 1992) ("Under one view, the good faith requirement of § 1129(a)(3) is met if the plan will fairly achieve a result consistent with the objectives and purposes of the Bankruptcy Code. . . . Under another view, the good faith requirement is met if the plan was proposed with honesty and good intentions, and with a basis for expecting that a reorganization can be effected. . . . Under a third view, good faith requires fundamental fairness in dealing with one's creditors."). See also *Mutual Life Ins. Co. of N.Y. v. Patrician St. Joseph Partners Ltd. Partnership* (*In re Patrician St. Joseph Partners Ltd. Partnership*), 169 B.R. 669 (D. Ariz. 1994).

¹⁹³ Compare 11 U.S.C. § 1121(b) (1988) (stating that only the debtor, not the debtor in possession or other estate representative, may file a plan during first 120 days of case) with 11 U.S.C. § 1129(c) (1988) (in case of two confirmable plans, the court is directed to consider "the preferences of creditors and equity security holders in determining which plan to confirm").

¹⁹⁴ See, e.g., *In re Bryson Properties XVIII*, 961 F.2d 496, 502 (4th Cir. 1992) (stating that a debtor must be prohibited from "manipulating" voting); *Lumber Exch. Bldng. Ltd. Partnership v. Mutual Life Ins. Co.* (*In re Lumber Exch. Bldng. Ltd. Partnership*), 968 F.2d 647, 649 (8th Cir.

Good faith limitations should handle this objection adequately.¹⁹⁵

Some might think, however, that there is something odd in the creation of a one-creditor class, but this objection is too narrow to be persuasive. The next section demonstrates the narrowness of this objection by applying the proposed test to common classification schemes already approved by courts.

1. Secured Claims and Equity Interests

The first step in evaluating the proposed test is to recall that current practice validates, and even mandates, single-creditor classes in some cases. Perhaps the most common single-creditor classes are holders of secured claims. Courts have routinely classified these types of claims separately from unsecured creditors, at least implicitly recognizing that the difference in liquidation priorities justifies such action.¹⁹⁶

Even claims secured against the same collateral can result in separate classification.¹⁹⁷ In these cases, separate classification occurs because each secured claim holds a different priority in the same collateral.

At the other end of the spectrum, separate classification is also the rule and not the exception. Usually, different classes of equity securities are explicitly distinguished by virtue of different non-bankruptcy liquidation priorities and, therefore, must be classified separately.¹⁹⁸ In small companies, this can often result in one-creditor classes.

2. Deficiency Claims—Both Recourse and Non-recourse

One distinct feature of the Code is that it bifurcates undersecured

1992) (holding that debtor cannot be allowed to manipulate voting); *Phoenix Mut. Life Ins. Co. v. Greystone III Joint Venture* (*In re Greystone III Joint Venture*), 995 F.2d 1274 (5th Cir. 1991) (holding that the debtor must not be allowed to "manipulate" acceptance through "artful classification"); *Hanson v. First Bank*, 828 F.2d 1310, 1313 (8th Cir. 1987) (finding that debtor cannot be allowed to classify claims solely to manipulate voting); *In re Jersey City Medical Ctr.*, 817 F.2d 1055, 1060-61 (3d Cir. 1987); *Washington Assocs. v. Citibank, N.A.* (*In re Washington Assocs.*), 147 B.R. 827, 830 (E.D.N.Y. 1992).

¹⁹⁵ See *supra* note 192 and accompanying text. See also *Carlson, supra* note 7, at 610-14; *Rusch, Gerrymandering and Classification, supra* note 7, at 202-04.

¹⁹⁶ See *Brady v. Andrew* (*In re Commercial West Fin. Corp.*), 761 F.2d 1329 (9th Cir. 1985); 5 COLLIER ON BANKRUPTCY, *supra* note 178, at ¶ 1122-14-17; BROUDE, *supra* note 15, at ¶ 9.02[1]. But see *In re Plaisades-on-the-Desplaines*, 89 F.2d 214, 217-18 (7th Cir. 1937) (finding that first mortgagees each holding liens of separate properties classified together under chapter X plan).

¹⁹⁷ For example, the holder of a mechanic's lien against real property and a holder of a consensual mortgage against that same property should be in separate classes. *Kyser v. MacAdam*, 117 F.2d 232, 236-37 (2d Cir. 1941). See 5 COLLIER ON BANKRUPTCY, *supra* note 178, at ¶ 1122-15 n.31a.

¹⁹⁸ COLLIER ON BANKRUPTCY, *supra* note 29, at ¶ 1602.

claims. In other words, it treats the holder of a secured claim for which the collateral is worth less than the debt owed as holding two claims — a secured claim equal to the value of the collateral, and a deficiency, or unsecured, claim for the remainder.¹⁹⁹

As set forth above, these bifurcated claims have different non-bankruptcy priorities.²⁰⁰ The secured claim will be paid out of the collateral, and the unsecured claim will be paid pro rata with all other unsecured claims. Given the logic of the cases set forth above, it follows that the secured claim should be separately classified.

Can they be classified together? Under the proposed test, the liquidation priorities are different, so they should not be combined. The only exception would be if the holder of the secured claim consents, and if the only source of payment to the class would be collateral proceeds.²⁰¹ In that case, the secured creditor effectively waives its unsecured claim because the collateral is worth less than the claim, and the only source of repayment would be the collateral proceeds.

This discussion leads to the conclusion that, in at least those cases in which the lender has a non-bankruptcy deficiency claim, it should be permissible to combine the deficiency claim with all other unsecured claims. This would create a class in which all members' claims have the same liquidation priority. It would, therefore, be presumptively proper. Plan proponents who are not the holders of such claims, however, may have incentives to separate the claims. Can they do this? Must they do it?

Under the proposed test, classification must be separate if the deficiency claim is recognized only by virtue of the application of section 1111(b).²⁰² Since these claims have a different non-bankruptcy liquidation priority, combining them would dilute one group's non-bankruptcy enti-

¹⁹⁹ 11 U.S.C. § 506(a) (1988).

²⁰⁰ *In re Richard Buick, Inc.*, 126 B.R. 840, 853 (Bankr. E.D. Pa. 1991).

²⁰¹ If the plan proponent structured the plan so that non-collateral proceeds would be used to pay the combined class, then other unsecured creditors could successfully allege that the plan combined claims which were not "substantially similar." 11 U.S.C. § 1122(a)(1988). Their damage would be the diversion of going concern surplus to a class having a different liquidation priority. Alternatively, the class could dissent and claim that any disparity in payment was because the classification unfairly discriminated in violation of § 1129(b)(1).

²⁰² 11 U.S.C. § 1111(b) (1988). This can happen in at least three circumstances. First, the claim can be non-recourse by contract. This will be the case with many single asset debtors because their lenders agreed to look only to the value of the security. Second, the claim can be non-recourse for lack of privity, such as when a debtor obtains property subject to an existing lien, and the value of the property obtained is less than the debt secured. *See* 680 Fifth Ave. Assocs. v. Mutual Benefit Life Ins. Co. (*In re* 680 Fifth Ave. Assocs.), 29 F.3d 95, 98 (2d Cir. 1994). Or, third, it can arise by operation of law, such as the application of state anti-deficiency statutes.

tlements. The example above²⁰³ demonstrates how this is possible, as does Professor Carlson's solvent general partner example.²⁰⁴

Do not forget, however, about non-mandatory separate classification. This would arise when the lender's deficiency claim is entitled to share pro rata under non-bankruptcy law with other unsecured claims, but is isolated in a one-creditor, dissenting class. The holder of the deficiency claim has three protections in this instance without relying on allegedly bad classification. First, the plan must comply with the "fair and equitable" rule.²⁰⁵ This means that all reorganization value must be allocated to the dissenting class before any junior class receives anything. Second, the plan must not "discriminate unfairly" against the dissenting class. In short, the payment made and its terms must not unreasonably favor one class to the detriment of the dissenting class. Finally, the plan must be proposed in good faith. That is, it must reasonably be expected to achieve results consistent with the Bankruptcy Code.

In this context, the treatment of the separately-classed creditor should bear no relation to the satisfaction of the requirements of section 1129(a)(10). Since the separately-classed creditor has all the protections listed above, there is no need to investigate impairment in those consenting classes beyond the level required in section 1124. Those who express outrage or find fault with such separate classification either forget the protections afforded dissenting classes by the Code, or are not satisfied with (and not completely honest about) the level of protection that the Code does provide.

There is another way to look at the issue. By opting for liquidation, the lender takes all the risk and gets all the reward of any uncertainties in value or any upswings in price. Any gain over values realized at foreclosure is the lender's and the lender's alone.²⁰⁶ That fact may influence lenders' motives towards liquidating the property of the debtor. Put another way, not all players may have the same incentive to realize for the benefit of all participants the excess of reorganization value over liquidation value.

Separate classification can thus restore the balance by counting the

²⁰³ See *supra* notes 104-09 and accompanying text.

²⁰⁴ See Carlson, *supra* note 7.

²⁰⁵ 11 U.S.C. § 1129(b)(1) (1988).

²⁰⁶ *Id.* BARKLEY CLARK, THE LAW OF SECURED TRANSACTIONS UNDER THE UNIFORM COMMERCIAL CODE ¶ 4.09[2], at 4-178 (rev. ed. 1993); JAMES J. WHITE & ROBERT S. SUMMERS, UNIFORM COMMERCIAL CODE § 25-9, at 1214 (3d ed. 1988); 2 GRANT GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY § 44.6, at 1245 (1965).

votes of only creditors truly interested in reorganization.²⁰⁷ Those who dissent, the holders of recourse deficiency claims, must receive treatment which is fair and equitable and not unfairly discriminatory. That is their ultimate protection. If the reorganization goal has any independent vitality, an evaluation of motives should tip the scales in close cases in favor of permitting separate classification.

3. *Regular Trade Claims*

Under the proposed test, a class consisting of any combination of unsecured creditors is permitted.²⁰⁸ Evidence of this protection is that if any class dissents, it will always have the right to invoke its absolute priority and anti-discrimination rights under section 1129(b).²⁰⁹

The other reason to allow such separate classification is practical. One aspect of the history of classification is the continuous effort to find appropriate acceptance levels necessary to bind non-consenting creditors. Classification is bound not only to liquidation priorities, but also to post-confirmation treatment. The ability to separately classify is the ability to treat certain creditors differently.²¹⁰

With most business debtors, there are several instances in which differential treatment is desirable. Different groups of creditors may have different risk preferences. Trade creditors may be more concerned with the preservation of a customer or supplier, and may take equity interests in reorganization; institutional investors may simply wish to receive cash. Tort claimants may have no incentive to keep the business intact; ordinary course of business creditors may have every incentive. The point is that if classification is equivalent to liquidation priority, then plan proponents lose great flexibility in structuring their plans so as to maximize recovery. Given the preference for reorganization over liquidation, this may not make sense.²¹¹

²⁰⁷ If the plan proponent cannot return more than liquidation value to creditors, the case should be dismissed anyway since the plan proponent will not be able to meet the requirements of § 1129(a)(7).

²⁰⁸ Indeed, the legislative history seems to take as a given that unsecured creditors could be placed in more than one class. H.R. REP. NO. 595, 95th Cong., 1st Sess. 416 (1977). See BROUDE, *supra* note 15, at ¶ 9.02[2].

²⁰⁹ These rights are in addition to receiving the benefit of the normal showings a plan proponent must make, such as a showing that the plan is proposed in good faith, that the plan is in the best interests of creditors, and that the plan is feasible.

²¹⁰ See *Brinkely v. Chase Manhattan Mortgage & Realty Trust (In re Le Blanc)*, 622 F.2d 872, 879 (5th Cir. 1980); BROUDE, *supra* note 15, at ¶ 9-13.

²¹¹ See COLLIER ON BANKRUPTCY, *supra* note 178, at ¶ 1122.04, at 1122-20.

In the most common case, trade creditors are willing to take more risk, and institutional creditors will opt for more immediate payment. Under our current system, this problem is resolved by group negotiation, bounded by dissenting parties being able to invoke the cramdown and confirmation protections mentioned above. To give such negotiation more fluidity, the ability to treat creditors differently is critical. That ability is protected by the ability to classify separately.

4. *Other Possible Combinations*

Classification is mechanical and easy to apply partly because it is difficult to anticipate all possible circumstances in which separate classification may be appropriate. So long as the various good faith and other concerns exist, however, a link between classification and subjective motive is not necessary or appropriate.

So when else may a plan proponent separate creditors having the same liquidation priority? Creditors whose interests are wholly antithetical to reorganization may present a compelling case for separate classification.²¹² For example, a competitor who has obtained a judgment, or has a claim, for unfair competition may want to rid itself of the debtor. Relations between a landlord and its tenant may have deteriorated to the point of impasse. Groups such as trade unions may have reputations for toughness at stake which exceed the private stake in the particular reorganization.²¹³

These types of creditors are "irritants" in the sense that their interests are contrary to the reorganization goal of chapter 11. This does not mean that their claims are less-deserving. It does suggest, however, that not all of the creditors have equal, or even similar, interests in the continuation of the debtor.

Cases also exist in which separate classification may be needed to meet policy concerns.²¹⁴ A plan which proposes to distribute stock in the

²¹² See, e.g., *Steelcase Inc. v. Johnston (In re Johnston)*, 21 F.3d 323, 328 (9th Cir. 1994) (finding it proper to separately classify unsecured claim which is being hotly disputed in separate litigation); *Teamsters Nat'l Freight Indus. Negotiating Comm. v. United States Truck Co. (In re United States Truck Co.)*, 800 F.2d 581, 587 (6th Cir. 1986) (upholding separate classification of labor union based on such entity's "non-creditor" interests in reorganization).

²¹³ *United States Truck Co.*, 800 F.2d at 587 (noting that labor union had "non-creditor" interests to protect in reorganization).

²¹⁴ See, e.g., *Frito-Lay, v. LTV Steel Co. (In re Chateaugay Corp.)*, 10 F.3d 944, 956-57 (2d Cir. 1993) (separate classification of tax lessors based upon whether they independently provided debtor in possession financing); *Heartland Fed. Sav. & Loan Ass'n v. Briscoe Enter., Ltd., II (In re Briscoe Enter., Ltd., II)*, 994 F.2d 1160, 1167 (5th Cir. 1993) (upholding separate classification in

reorganized debtor in cancellation of claims may give rise to antitrust or other similar claims. If a governmental entity holds a claim due to the structure of a subsidy or other program offering non-market pricing, separate classification of that claim to obtain separate treatment is appropriate, even if it creates a single-creditor class.²¹⁵ Similarly, a governmental program may artificially designate a subsidy as a debt, and payment of that subsidy might prejudice the claims of normal creditors.²¹⁶ Finally, some courts have separately classified tort claims from claims incurred in the normal course of business.²¹⁷

Lastly, can creditors be separately classified based on subordination provisions?²¹⁸ The proposed test would allow this.²¹⁹ All unsecured, non-priority creditors are the same to the debtor because quite often the debtor is not even a party to the subordination agreement. Since the creditors all have the same non-bankruptcy liquidation priority, as seen above, the plan proponent may classify the claim in any manner it wishes. The fact that the creditors are the same as far as the debtor is concerned also dispenses with the question of whether the claims *must* be classified together; they may, or they may not.

May the plan combine junior and senior unsecured creditors in the same class? Again, if subordination works as a two-step process — one distribution to creditors, and a second among creditors in accordance with the subordination agreement — the proposed test permits the combining of the class. Although this affects the negotiation process, it actually seeks to restore the relative positions of the parties set by the subordination

single-asset real estate case for the City of Fort Worth which contributed cash to subsidize rentals in moderate to low income housing).

²¹⁵ *Mickerson v. Leser (In re Leser)*, 939 F.2d 669 (8th Cir. 1991) (finding it proper to separately classify and provide different treatment for child support payments).

²¹⁶ *In re Mason & Dixon Lines, Inc.*, 63 B.R. 178 (Bankr. M.D.N.C. 1986); BROUDE, *supra* note 15, at ¶ 9.14.

²¹⁷ *John Hancock Mut. Life Ins. Co. v. Route 37 Business Park Assocs.*, 987 F.2d 154, 158-59 (3d Cir. 1993) (approving and explaining *In re Jersey City Medical Ctr.*, 817 F.2d 1055, 1061 (3d Cir. 1987), in which separate classification of medical malpractice tort claims, non-priority pension claims, and trade creditors was upheld); *In re EBP, Inc.*, 172 B.R. 241 (Bankr. N.D. Ohio 1994); *Hi-Lo Powered Scaffolding, Inc. v. Penn (In re Hi-Lo Powered Scaffolding, Inc.)*, 70 B.R. 606 (Bankr. S.D. Ohio 1987).

²¹⁸ This discussion addresses contractual subordination only. Actions which would result in equitable subordination, authorized by § 510(c), may also justify separate classification. *Olympia & York Fla. Equity Corp. v. Bank of N.Y. (In re Holywell Corp.)*, 913 F.2d 873 (11th Cir. 1990).

²¹⁹ The issue of classification of subordinated claims is also discussed in 5 COLLIER ON BANKRUPTCY, *supra* note 178, at ¶ 1122.03, at 1122-13; BROUDE, *supra* note 15, at ¶ 9.02[3]; Carlson, *supra* note 7, at 596-98; Daniel C. Cohn, *Subordinated Claims: Their Classification and Voting Under Chapter 11 of the Bankruptcy Code*, 56 AM. BANKR. L.J. 293 (1982).

agreement. It allows the larger party to control the reorganization, while section 510(a) preserves the benefit of the subordination bargain for all plan treatment.²²⁰

V. CONCLUSION

Classification can be a confusing issue, especially if its historical origins are not considered. It also can lead one astray if it is viewed as an end in itself, rather than as a part of a coordinated and complex scheme for achieving reorganization.

Many parts of the reorganization process both require and rely upon flexible classification. Those adversely affected by classification generally have recourse through the general requirements of confirmation—good faith, the best interests of creditors test, and feasibility. If those adversely affected are members of a dissenting class, they also have the benefit of the special requirements of cramdown, which includes the availability of the absolute priority rule and the prohibition against unfair discrimination in treatment. This article has argued that a court should reject a proposed classification only if it negatively affects these general protections.

As recognized by section 1122, negative impact arises only when a plan proponent combines claims or interests having different non-bankruptcy priorities into one class. When that occurs, the class rights anticipated and protected by the cramdown powers become diluted. Although instances of these types of classification rarely occur, they should be disallowed.

In other cases, however, classification should be relatively open and free. Such a result is consistent with the historical roots of classification. Classification was originally used to ensure that creditors who voted together had the same interest in the debtor, judged primarily, but not exclusively, by their relative liquidation priorities as against the debtor. Open and free classification also comports with the Bankruptcy Code's text. When the plan proponent's motive becomes an element to be adduced in the context of claim classification, however, the system loses much of its predictability. Unfortunately, many courts seem clueless on this point.

To attempt to restore classification to its proper place, this article has suggested that any classification is presumptively permissible so long as it

²²⁰ The legislative history of the Code makes clear that a class vote in bankruptcy can change the terms of the instrument containing the terms of the subordination. H.R. REP. NO. 595, 95th Cong., 1st Sess. 359 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5787.

does not combine participants with different non-bankruptcy liquidation priorities. To the extent that this formulation permits single-creditor classes, and classes not generally permitted by many courts, this is acknowledged and explained. In the end, perceived abuses should be regulated, not through mangling the words of section 1122, but through applying the other and varied protections provided under the Code to all creditors.

